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MISCELLANEOUS TAX ISSUES

HEARING

BEFORE THE

SUBCOMMITTEE ON
TAXATION AND DEBT MANAGEMENT

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDREDTH CONGRESS

FIRST SESSION

ON

S. 788, S. 983, and S. 1781

NOVEMBER 13, 1987

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MISCELLANEOUS TAX ISSUES

FRIDAY, NOVEMBER 13, 1987

U.S. SENATE,
COMMITTEE ON FINANCE,
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT,
Washington, DC.

The Subcommittee met, pursuant to notice, at 9:30 a.m. in Room SD 215, Dirksen Senate Office Building, the Honorable Max Baucus (Chairman) presiding.

Present: Senators Baucus, Danforth and Chafee.

[The press release announcing the hearing follows:]

[A description of tax bills S. 788, S. 983, and S. 1781 appears in the appendix.]

FINANCE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT TO HOLD HEARING ON MISCELLANEOUS TAX ISSUES

WASHINGTON, DC.—Senator Max Baucus (D., Montana), Chairman of the Senate Finance Subcommittee on Taxation and Debt Management announced Tuesday that the Subcommittee will hold a hearing to examine two proposals that would establish Enterprise Zones for designated areas of rural America (S. 983) and for Indian reservations (S. 788), and a proposal concerning the treatment of charitable contributions of third world debt (S. 1781).

The hearing is scheduled for Friday, November 13, 1987 at 9:30 a.m. in room SD-215 of the Dirksen Senate Office Building.

Baucus said, "By offering tax and regulatory incentives, Enterprise Zones are intended to attract businesses to severely depressed areas and to encourage local firms to stay and expand."

"Rural America lags behind urban America in measurable indicators of income, education, and housing. Low prices for farm products, the oil glut, and import competition impose new stresses on small towns. Similarly, many Indian reservations suffer from economic depression. The plight of these areas calls upon us to carefully consider the available alternatives for providing effective assistance," said Baucus.

"The hearing will also examine a proposal to allow donors to claim a charitable contribution deduction equal to their basis in third world debt where such debt is contributed to world conservation organizations," Baucus said.

OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM THE STATE OF MONTANA, CHAIRMAN OF THE SUBCOMMITTEE

Senator BAUCUS. The hearing of the Subcommittee on Miscellaneous Tax Matters and Debt Management will come to order.

Today's hearing includes several bills. Two of the bills are in one area, the third bill in a second area. The first area concerns Enterprise Zones. All of us are interested in economic development, but there are some parts of our country that need economic development more than other parts. Our Indian Reservations certainly have mixed economic development, at best. Generally, development in incomes and unemployment levels on our Indian Reservations are much worse than the national averages, and it is very important that we find the right way to encourage development on our Indian Reservations.

It is also important to foster rural economic development. It is my strong view that this country is becoming more and more in the nature of swiss cheese—that is, there are strong bright spots in our national economy, and there are very depressing weak spots in our national economy. The bright spots tend to be on the coasts, in the Coastal States and the Sunbelt States. The very weak spots tend to be in the hinterland or natural resource States, rural States.

It is very clear that if our country is going to be a strong, prosperous nation, we have to be a unified strong country with strong, widespread, and broad economic growth.

Abraham Lincoln once said a house divided cannot stand. He, of course, was referring to the Northern and Southern States at the beginning of the civil war. That same observation can be made of our national economy—that is, a nation divided between a prosperous America and a poor America cannot stand.

Our national motto is "E Pluribus Unum"—one out of many. Even though that applies specifically to States, I think it also figuratively applies to our national economy.

It is my hope that these bills, these Enterprize Zone bills, will move us in the direction of economic growth. These bills have some questions that revolve around them that should be answsered; but, nevertheless, economic development should be more of a primary goal of this Congress, particularly as it pertains to world economic development.

The third bill pertains to another area of concern, Third World debt, and also the degree to which banks can transform that debt by aid to conservation organizations, particularly in countries like Brazil where the rain forests are deteriorating at an alarming rate.

I am very pleased this morning to have as our first witness the Honorable John McCain, Senator from Arizona. Senator McCain has been a strong advocate in the development of Enterprise Zones, particularly as they apply to Indian Reservations. Senator, we are very happy to have you here.

STATEMENT OF HON. JOHN McCAIN, A U.S. SENATOR FROM THE STATE OF ARIZONA

Senator McCain. Thank you, Mr. Chairman.

Mr. Chairman, I would like to thank you first of all for agreeing to hold this hearing. It is a very busy time for all of us in the cycle, and I appreciate your continued commitment and abiding interest in the problems that exist in rural America and also on Indian Reservations. So, again, thank you very much.

Mr. Chairman, I have a statement that I would like, with your permission, to be made part of the record. I know you have a full schedule this morning; I will try to be brief in my remarks.

Senator Baucus. It will be included.

Senator McCain. Mr. Chairman, we have a situation in America today where we have Third World nations that exist within the borders of our country. The numbers are staggering. Unfortunately, they don't appear to be improving, and the aspect of it that is most disturbing to me is the lack of attention or concern on the part of the Congress and the American people to this issue.

There are few areas in our nation that are suffering from more terrible living conditions than the Indian Reservations. Unemployment? The numbers run somewhere 30, 40, 50 percent, depending on who you talk to; but when you look at the fact that the majority of jobs on Indian Reservations come from two sources—one, the BIA, or two, the Tribal Government—the numbers are even more compelling.

Young Indian people are committing suicide at three times the national average, others turn to alcohol and substance abuse; more than 90,000 Indian families are in need of housing assistance. According to the 1980 Census, 14 percent of all Indian Reservation households had incomes of less than $2500 a year as compared with five percent for the U.S. as a whole. Only six percent of Reservation households had incomes greater than $30,000 a year, as compared with 20 percent in the U.S. as a whole. Forty-one percent of Reservation Indians were living in households with incomes below the poverty level.

The numbers go on, Mr. Chairman. I could tell you gripping and terrible stories about young Indian boys and girls before they are in their teens who are addicted to glue, paint, Lysol. I could tell you stories about the increased incidence of fetal alcohol syndrome. I could tell you stories of Reservations on which exist schools where half of them are shut down because of shoddy construction. I can tell you examples of housing projects that go unused for years after they are built because of bureaucratic fights between the Indian Health Service and the BIA. But I won't take your time doing that, Mr. Chairman.

What I would like to point out to you, for your consideration, is that the Arizona Republic recently published a series of articles entitled "Fraud in Indian Country—A Billion Dollar Betrayal." Actually it is a multi-billion dollar betrayal. It is perhaps the best presentation of the problems that afflict Native Americans and the best depiction I know of of the failure of the United States of America to fulfill the obligation to the Indian people that we agreed to assume by solemn treaties that we made with Native Americans many years ago.

Mr. Chairman, I am not here in a plea to provide more money for Indian programs. I think that is a requirement, but that is not the subject of this legislation, because this series of articles would indicate very clearly that billions of those dollars have been mismanaged, a fraudulent abuse to a degree which I have said in the past makes the Department of Defense look like a well-oiled, smooth-running bureaucracy compared with what they have done.

Mr. Chairman, what I am seeking is the consideration of this committee and the Congress to set up economic Enterprise Zones. I won't go into the details or the laundry list of the incentives that would need to be provided under this Act. But it is very clear today that businesses will not locate on Indian Reservations, just like businesses would not locate in inner cities in America, unless there are incentives in place for them to do so.

I will admit freely to you, Mr. Chairman, that these incentives are wide in encompassment and broad in nature. I would also suggest to you that if we have a large segment of our population existing on Indian Reservations for which we have to pay for their livelihood by the use of taxpayers' dollars rather than providing them with an opportunity for jobs, in the long run it will prove again what we found out in the past, that it will be a net loss for the U.S. Treasury as opposed to any addition that it could provide.

Finally, Mr. Chairman, I believe that we have an obligation to all of our citizens. Those obligations vary with the ideas and views that we have of the role of the Federal Government.

I think we are all in agreement, at minimum, that we owe all of our citizens an equal economic opportunity. Today on Indian Reservations across America, Indians do not have an equal economic opportunity. In my opinion, we have an obligation and a duty to provide them with that opportunity. I do not view this legislation as a panacea or a cure-all for all of these problems that have indeed been festering for over 200 years; but I do say that it is time that we took a new approach to the endemic problems of poverty and despair that exist on Indian Reservations across America, and at least make a fresh attempt at trying to provide them with that opportunity which we owe them.

I thank you, Mr. Chairman, for the opportunity to be here, and I hope that this committee will at least view with some consideration this legislation.

Thank you, Mr. Chairman.

[The prepared statement of Senator McCain appears in the appendix.]

Senator BAUCUS. Thank you, Senator.

I am curious—what kinds of jobs do you think this bill would help to encourage and stimulate? Are you referring to small business development? Or would larger companies set up and move on to Reservations if this bill were passed? Would the new jobs be more in the nature of manufacturing industries, or would they be more in the nature of service industries? I am curious about how you see the nature of the jobs and firms developing if this bill passes.

Senator MCCAIN. Mr. Chairman, I believe that they would be both, and a lot of it depends on the location of the Reservation and the type of area in which they exist.

We recently had a so-called "economic summit", at Tohatchi, New Mexico, that was convened by Chairman McDonald, and we had representatives from various companies and corporations throughout America in attendance. Many believe that they would be willing to invest and locate on Indian Reservations, given that a variety of conditions were met.

One of the reasons why it is hard to definitively say whether they would be large or small companies is because large companies would like to move in, such as companies like General Dynamics and others who have shown an interest. But on other Reservations that are near metropolitan areas, there are proposals to build shopping malls and other kinds of infrastructures which lend themselves to small as opposed to large businesses.

I think it is very clear, Mr. Chairman—and I hate to be repetitive—that there is a great deal of reluctance out there, an enormous reluctance on the part of businesses, as later witnesses will tell you, in locating on the Indian Reservations for a variety of reasons. Businesses want to be sure that their investment will be protected when they do locate and that they are not subject to the vagaries of tribal politics, which has happened in the past, unfortunately.

Senator BAUCUS. A final question. You know, the major trend of the philosophy of the last Tax Act, the 1986 Act—which the Senator from Missouri, who is now present, voted against—is to broaden the base,"lower the rates, broaden the base." The basic philosophic underpinning of that Act was, you know, that tax incentives shouldn't make that much difference, that businessmen should spend more time building the better product and less time building the better tax break. That is a very basic underpinning of the 1986 Act; and yet, here we are with a bill whose underpinning is in the exact opposite direction; namely, incentives, because the theory is that tax incentives do make a difference.

I am just curious as to how you see those seemingly contradictory philosophies resolving.

Senator MCCAIN. Thank you, Mr. Chairman. I think there is a great deal of credence to the philosophy that did, as you mentioned, underpin the 1986 tax reform legislation.

But let me point out that we already have a proven model for these economic enterprise zones. The closest parallel to the conditions that exist on Indian Reservations in America today are those that exist in inner cities across America. Forty-three cities in America have set up economic enterprise zones, and they have created approximately 90,000 new jobs. Those jobs were previously hard-core unemployed. And every businessman who has been consulted on this issue will maintain unequivocally that there is no way they would have moved into the inner cities had there not been incentives for them to do so.

So I would suggest that this legislation is not incompatible, in that there are specific areas in the country such as inner cities across America, such as Indian Reservations, where there simply needs to be at least temporarily some kind of incentive for them to locate on the the Reservations.

In Phoenix, Arizona, Mr. Chairman, there is a major artery that separates an Indian Reservation from Scottsdale, Arizona. On one side of the road, on the non-Indian side, there are shopping centers, apartments, stores, shops. And on the other side is basically totally undeveloped or at least dramatically underdeveloped land on the Indian side. The Indians are eager to have businesses come on that Reservation; but, so far, they have been unable to attract those businesses because they have been unable to provide the incentives that are necessary to do so.

I am sorry for this long answer, but one of our biggest problems in addressing Indian issues, as you well know, Mr. Chairman, is that we try to treat every Indian Reservation the same. We have a Reservation in Arizona such as I mentioned, which is right next to and in fact included in the metropolitan area, and then we also have the Havasupai who live down at the bottom of the Grand

Canyon; it is a three hour hike to get there. Now, to enact blanket legislation or blanket programs that apply to both of those tribes, I would suggest, is very difficult, if not impossible.

And this legislation might be of enormous help to the Maricopa-Pima community, because they are ready to and have an atmosphere and environment where this would be very helpful. Honestly, I don't think this is going to help the Havasupai. I don't think it is going to be a benefit to them. We are going to have to design other programs, I think, to address their problems.

So, I think there is one thing that is abundantly clear: Unless there are some kinds of incentives for businesses to be on Indian Reservations, we are going to see a continuation of the kinds of conditions that exist today. This may not be the exact answer. I would be more than happy—I would be grateful for the input and recommendations of the distinguished members of this committee in helping design it so that it is more efficient.

But I know of no one who can tell you and make a case that Indian tribal economies have improved in the last 50 years, despite all the great efforts we have made and the billions of dollars in public tax dollars that we have expended.

Senator BAUCUS. Thank you, Senator. Following the committee early-bird rule, the first to arrive will be first.

Senator Danforth.

Senator DANFORTH. No questions, Mr. Chairman.

Senator BAUCUS. Our next Senator to arrive was Senator Chafee.

OPENING STATEMENT OF HON. JOHN H. CHAFEE, A U.S. SENATOR FROM THE STATE OF RHODE ISLAND

Senator CHAFEE. Thank you, Mr. Chairman.

First, I want to commend Senator McCain for this. I know he has been long interested in Indian problems and has given a lot of thoughtful attention to them, not only in connection with this but for many other Indian matters, and we are all grateful to you for giving us such leadership in this.

I think this has possibilities. We tried the economic zones before, free enterprise zones, and it was not passed. But that is all right; there are different approaches to all of this. I think from the statistics, we had better try something.

I must say I was shocked to read in your testimony that on some of the Indian Reservations there is 30 to 90 percent unemployment. I mean, 90 percent unemployment is total unemployment. Maybe this isn't the answer, but we have to attempt something along this line or we will get nowhere, because many other things have been tried, as you pointed out in your testimony, like providing grants, subsidizing loans, loan guarantees, and interest subsidies. But let us get the private sector involved and particularly, as you pointed out in your illustration, where one side of the road is the non-Reservation territory and things are going well, and the other side of the road is the Indian Reservation where things just aren't going well.

Maybe this will do the trick. I think it is worth a try. I appreciate your bringing it to our attention.

Thank you, Mr. Chairman.

[The prepared statement of Senator Chafee appears in the appendix.]

Senator McCAIN. Thank you. Not to try to dramatize this too much, although I don't know how I could, there is another Reservation in Arizona where the tribal chairman told me that 75 percent of the young men under 16 on his Reservation were addicted to paint, glue, or Lysol. Now, he said this to me in connection with my comments to him about how we could implement a drug abuse program. He said, "You are too late, you know; we don't have a problem with drugs, it is paint, glue, and Lysol." And I asked him why that is, and he said, "Because they have no hope. They have no hope for an economic future." And until we provide those young Americans, Native Americans, with some kind of hope for the future, we are going to see conditions worsen rather than get better.

I also would like to mention, Mr. Chafee, if I could, that we have some significant Democrat support, members who have opposed economic enterprise zones and who now are in support of this bill, specifically Chairman Mo Udall on the House side.

That is why I hesitate to bring up the comparison, because I know there is a certain bias against economic enterprise zones, and I hope we could get over that and look perhaps at this issue as different, at least in some respects.

Senator CHAFEE. Sure. Thank you.

Senator BAUCUS. Thank you, Senator, very much. We appreciate your testimony.

Senator McCAIN. Thank you, Mr. Chairman.

Senator BAUCUS. Our next witness is the Senator from Missouri, Senator Kit Bond, here to testify on another variety of enterprise zones, rural enterprise zones.

Senator, welcome to the committee.

STATEMENT OF HON. CHRISTOPHER S. BOND, A U.S. SENATOR FROM THE STATE OF MISSOURI

Senator BOND. Thank you very much, Mr. Chairman and members of the subcommittee, I appreciate very much the opportunity to come before you to testify in strong support of S. 983, legislation which has been introduced by my senior colleague Senator Danforth, which would establish Federal rural enterprise zones. Along with a number of our colleagues, I am an original cosponsor of the bill.

I think it is important to point out, perhaps, at this time that currently we are discussing the conference report on the Housing Authorization Bill, and that legislation provides for the designation of 100 enterprise zones. It has a requirement that a minimum of one-third of the designations be made in rural areas, and the selection criteria are similar to those in this measure, S. 983.

Mr. Chairman, I have in my previous role as Governor spent a lot of time working on the problems of unemployment and under-employment in rural areas. I had the opportunity to participate with the OECD on a conference on rural development to discuss the problems that we face in this country and in other developed countries around the world. Without going into a lengthy discussion of it, suffice it to say that as we realize that agriculture has become far more capital-intensive and less labor-intensive, there has been a tremendous decline in the number of jobs available in rural areas. We see that in our State, and I trust that you see that, Mr. Chairman, also in your State as well.

In many out-State counties in Missouri, the biggest source of income is transfer payments Social Security and other retirement benefits for elderly citizens, and the young people have had to leave the small towns to find jobs elsewhere.

We looked at these problems in Missouri back in the early 1980s, and as Governor I recommended, worked for, and signed into law an enterprise zone law which was supported on a bipartisan basis by Democrats and Republicans and went into effect in 1983 in Missouri.

Like S. 983, the Missouri law requires cities and towns to meet relevant economic need and unemployment criteria in order to receive enterprise zone designation. Once designated, a business can claim an investment tax credit against its State taxes for 10 years. A company can also take $1200 in tax credits for each job it creates for unemployed individuals who live in the enterprise zone, and $400 per person if it has to provide specialized training. Finally, half of a new company's income is eligible for an exemption from State tax for up to 15 years.

Now, Mr. Chairman, there has been some question raised about whether these incentives work. I can tell you that the Missouri program has been a tremendous success. To date, 33 enterprise zones have been designated; they have resulted in 8,000 new jobs across the State and over $200 million in investment in new plant and equipment.

I understand that later today you will be hearing testimony on one of the program's great success stories, the town of Cuba, Missouri. We in Missouri are very proud of what that town has accomplished, and I am pleased that Dennis Roedemeier, the president of its industrial board, is going to describe its achievements for you today.

In summary, Mr. Chairman, our country's rural areas have taken a real beating over the past several years. They are an important part of our economic and social fabric, and they must not be abandoned.

I sincerely believe that enterprise zones are a practical and valuable tool for helping to revitalize the rural economy. I thank you for scheduling this hearing, and I would urge the subcommittee to give S. 983 its serious consideration.

Thank you.

[The prepared statement of Senator Bond appears in the appendix.]

Senator BAUCUS. Thank you, Senator.

Because you have direct experience in Missouri, I am just curious how you answer the charge some might make that, "Sure, Missouri provided 8,000 new jobs with the creation of enterprise zones," but the charge is, "Well, that is just a transfer of jobs. Those are jobs that have transferred from one part of Missouri to someplace else," or they are jobs that would have been there anyway. I am curious as to how you might respond to that, since you have some direct experience in dealing with it.

Senator **Bond**. I think those assertions just don't wash. We have found that sure, some jobs result as transfers from one area to another. But, quite frankly, we have seen very healthy signs that businesses which are considering expanding will find that the incentives in an enterprise zone are sufficient to encourage them to expand their operations and to create more jobs. This is one of the strengths of the program, when a businessman has to make a decision: "Do I invest new capital? Do I create new jobs? Try to earn more profits, or not?"

I believe the enterprise zone benefits can be seen to encourage, at least in some instances, the creation of new jobs that otherwise wouldn't be created.

Senator **Baucus**. Thank you.

Senator Danforth?

Senator **Danforth**. Senator Bond, I understand that in our State something like 62 percent of the income of farm families is derived from non-farm sources. Is it something like that?

Senator **Bond**. The figure that we had a couple of years ago, Senator, was 87 percent. Only 13 percent of farm families in Missouri in the mid-eighties earned their largest source of income from farming.

Senator **Danforth**. And therefore, for people who live on the farm, it is absolutely essential that there be alternative sources of income if they are going to keep their heads above water, is that right?

Senator **Bond**. A very significant part of the slightly more than 100,000 farms in Missouri need that additional income. They cannot make a living for the family just on the farm income alone.

Senator **Danforth**. Now, when we think about rural areas of the country or rural areas of our State, we are thinking about more than people who live on the farms themselves; we are thinking of the smaller communities and people who are not themselves farm families but who live in rural areas and who are dependent on the economy of those areas for their livelihoods, isn't that right?

Senator **Bond**. That is correct.

Senator **Danforth**. And it is a fair percentage—isn't it?—of the total number of people who live in rural areas who are in fact not farm families at all but people who are the local shopkeepers and otherwise provide services, and so forth.

Senator **Bond**. The numbers speak for themselves. In our State with five million people, we have only slightly more than 100,000 farms and about half our population lives in non-metropolitan areas.

Senator **Danforth**. Would you describe the conditions that a visitor would observe in one of the smaller cities of our State? Say that a member of this committee were to visit Trenton, Missouri and drive down the main street of Trenton. What would he see? What would be observed if he visited there?

Senator **Bond**. Unfortunately, in towns like Trenton, Missouri, and particularly across the northern part of our State, you will find boarded up stores and empty factories. Our State used to be a significant producer of shoes. There was a time with our very inept American League baseball team in St. Louis and our strong production of fine products by the Anheuser Busch company, we were known as "first in booze, first in shoes, and last in the American League." Unfortunately, the St. Louis Browns have left, and so have the shoes manufacturers, and you will find vacant shoe plants in many of these communities. You will find boarded-up stores. You will find also something else.

Senator **Danforth**. For Sale signs outside of houses.

Senator **Bond**. In many places they don't even bother to put them up anymore, because they just know that there are no buyers.

One of the things, Senator, that I think is important to note as well: When we studied the prospects for rural Missouri in the decade to come, the conclusion of the task force I assembled was that we were going to have only about 10 or 12 agricultural service centers. It used to be that each one of Missouri's 114 counties had a county seat that serviced agriculture and all related agrobusiness. Now it is no longer economic; they combine the services in fewer and fewer areas, and the related agrobusiness is dying off in many parts of rural Missouri as a significant employer.

Senator **Danforth**. Looking at the local and county government, the municipal and county governments in rural Missouri, has there been any effect of the decline in the farm economy and the decline in the rural business opportunities on the ability of local and country governments to provide services, infrastructure and the like?

Senator **Bond**. Senator, as you are well aware, across North Missouri there have been counties which are laying off workers, which are closing their courthouses. I talked to people in Grundy County just yesterday who pointed out that their county and other counties throughout Missouri are talking about consolidation of counties; they are exploring ways of providing services more economically because they do not have the basic infrastructure on a county-by-county basis to meet the vital needs of their citizens.

Senator **Danforth**. Do you view providing tax incentives for work as a way of attracting businesses to the rural communities? Does it work in Missouri?

Senator **Bond**. I think it is a very strong tool. I believe the success stories document it. I think you are going to have an opportunity to hear today from some people who are involved in that program who will tell you, will give you specific chapter and verse on how it works. I am convinced it does.

Senator **Danforth**. I just have one more question, Mr. Chairman.

Do you think that providing tax incentives for businesses to locate and grow in the smaller communities will lead to a reduction in revenue for local governments or for the State Government?

Senator **Bond**. I think one of the interesting things I would point out to the subcommittee is that we adopted this enterprise zone law in Missouri in the middle of one of the worst budget crunches the State has ever been through. I won't give you the political history of what happened in Missouri, but when I came back into office as Governor in 1981 we had a $270 million deficit in our budget. We went into the recession, which hit Missouri hard, and while we were scraping to try and save money and were cutting back, we adopted the enterprise zone law because we felt that it would generate revenue, it would lessen the demand on the State for transfer payments, and frankly I think it was a good investment.

Senator DANFORTH. Thank you.

Senator BAUCUS. Senator Chafee?

Senator CHAFEE. Thank you, Mr. Chairman.

Senator Bond, I just wanted to ask you a couple of questions. Having been involved with this previously, on attempts on the Federal level to do what you did in Missouri, one of the objections we always used to have is: What good does it do to have all of the tax breaks if these companies that are start-up companies, many of them, don't have any profits to pay taxes on to start with? So, you are not giving them such a bonanza by giving them a tax break if they have no profits to pay taxes on to start with? What do you say to that?

Senator BOND. Well, we fooled a bunch of folks in Missouri who think that they are going to be profitable, and, basically, they want the opportunity to go in and make a profit. And it appears to be an incentive.

There may well be companies that are operating on a break-even level or that are not very profitable, but, frankly, they are generally not good sources of jobs. To the extent that there may be some for whom the tax breaks are not an effective inducement, there are many others for whom it is.

Senator CHAFEE. Well, how would you work it if say General Motors comes in and puts a plant in Missouri? Is that a separate entity for tax reasons, or is it just General Motors against its total profits nationally is entitled to the tax concessions that you have suggested, that for instance you did in Missouri?

Senator BOND. Well, tax concessions are structured to the enterprise zone. For example, the creation of jobs gives a tax credit, as I mentioned in my comments. You can get a $1,200 tax credit for each job that you created in the zone for unemployed people who live in the enterprise zone.

Senator CHAFEE. I understand that. But let's say General Motors puts a small parts plant there and does exactly what you want them to do, they hire 100 individuals. But they don't make any money on this particular plant; it is a start-up situation and not yet profitable. The $1,200 for tax credits for each job created, and let us say there are 100 jobs, goes against General Motors' overall profits earned nationally and internationally; it is not just attributable to the profits GM makes from this particular plant?

Senator BOND. That tax credit is not. That tax credit can be taken on General Motors' Missouri income tax for that year and succeeding years.

Senator CHAFEE. Okay, fine. Thank you very much. It is very helpful testimony, and I appreciate it.

Senator BAUCUS. Senator Bond, I am curious, which incentives seem to make the most difference?

Senator **Bond**. I am not sure which of the credits. I think they generally go together in our package. Perhaps Mr. Roedemeier will comment on the basis of his experience with potential companies. I think they are generally viewed as a package, and I do not believe that you could really single one out.

Senator **Baucus**. Now, does the same package necessarily apply to every new business or start-up business or continued business in an enterprise zone? Or does the State negotiate a different mix of incentives for different businesses in different zones?

Senator **Bond**. No. Once an enterprise zone is designated, it has to be sought by the local government officials. They have to designate a zone that has to meet certain requirements in terms of the poverty level, unemployed persons, a minimum of 4,000 people living in the zone. The State has fixed criteria that must be met. And then there are specific benefits that are available.

The local government has to give some breaks as well. They could, I suppose, give different local government benefits for different entities that come within the zone.

Senator **Baucus**. Thank you very much. I appreciate your help.

Senator **Bond**. Thank you, Mr. Chairman.

Senator **Baucus**. Our next witness is the Deputy Assistant Secretary for Tax Analysis, Office of the Assistant Secretary for Tax Policy at the United States Treasury, Mr. Eugene Steuerle.

Mr. Steuerle, I wonder if you might wait for just a few minutes? There is a vote going on now, and this would be a good opportunity for me to go over to the floor and vote.

So, I will recess the hearing for about 10 minutes.

[Whereupon, at 10:11 a.m., the hearing was recessed.]

AFTER RECESS

Senator **Baucus**. The hearing of the subcommittee will resume.

Mr. Steuerle, you are now front and center. I very much look forward to your views on these bills—actually, all three of them—with reference to revenue estimates and any other observations that the Treasury might have.

So, why don't you begin?

STATEMENT OF EUGENE STEUERLE, DEPUTY ASSISTANT SECRETARY (TAX ANALYSIS), OFFICE OF THE ASSISTANT SECRETARY FOR TAX POLICY, U.S. TREASURY, WASHINGTON, DC

Mr. **Steuerle**. Thank you, Senator.

With your permission, I will just highlight my testimony and submit the rest of it for the record.

Senator **Baucus**. Sure.

Mr. **Steuerle**. I appreciate the opportunity to appear before you to give the views of the Treasury Department regarding Indian enterprise zones, rural enterprise zones, and charitable contribution deductions allowable to persons who donate debt instruments issued by developing nations to certain U.S. charitable organizations.

I will discuss the enterprise zone bills first. The Administration has supported and continues to support experimental enterprise zone initiatives intended to relieve economic distress in inner cities, rural towns, and on Indian Reservations. The President's budgets as recently as fiscal year 1986 have included such a program. Congress, however, has never enacted proposed enterprise zone legislation.

The enterprise zone initiative offered by the Administration in the past was structured to create a free-market environment in depressed areas through the easing or removal of government burdens. Its success, however, was to depend largely on contributions by State and local governments through improved services and through relief from local taxes, regulations, and other burdens that could inhibit economic activity. It also depended upon the involvement of private organizations, neighborhood organizations, and private firms providing traditional services.

The Administration continues to support the enterprise zone concept as a constructive approach to assist structurally depressed local economies. However, we must consider any enterprise zone program in the context of current budget constraints. As you well know, budget negotiations are underway between the Administration and the Congress in order to reduce the budget deficit. Enactment of tax incentives for enterprise zones would reduce revenues, and thereby would require enactment of other measures to increase revenues or to reduce spending to achieve a given amount of deficit reduction.

Certainly, the Administration would support a greater amount of expenditure reduction in other programs to the extent that additional spending would be used for an enterprise zone program.

Moreover, the role of Federal tax incentives in any enterprise zone program should take into account the changes and compromises contained in the Tax Reform Act of 1986. In order to protect the economic gains from tax reform, the Administration is committed to support the compromises made in the negotiations leading to the passage of that Act.

Thus, the Administration believes that consideration of S. 788 and S. 983 should for the moment be deferred. Although we continue to support the enterprise zone concept, we believe that the current budget situation and the new tax reform law provide an opportunity to reassess the proper mix of tax incentives and other Federal programs intended to encourage business development in economically distressed areas most efficiently.

In the meantime, the Administration has requested budget authority of $5.3 billion in fiscal year 1988 for community and regional development, and has proposed legislation that would target this assistance toward the most needy communities. Some of the other speakers you have today will be speaking more to this.

The Administration also supports the current enterprise zone programs of State and local governments. These programs improve services, provide relief from local taxes, regulations, and other burdens that inhibit economic activity.

Under current law, tax incentives generally are not targeted to specific geographic areas. Although the Federal tax law contains incentives that may encourage economic development in economically depressed areas, they are not limited to use with respect to such areas.

My testimony contains a broad description of these various incentives, and I will just mention them very briefly here. They include the targeted jobs credit, which provides an incentive for employers to hire economically disadvantaged workers and is available to firms locating in economically distressed areas. An investment credit is also available for investment in low-income housing or the rehabilitation of certain structures.

Another type of incentive provides for the deferral of gains taxation upon certain transfers of low-income housing and certain exchanges of business or investment property. Also, State and local governments are permitted to issue a limited number of tax-exempt private activity bonds.

S. 788 would provide two tax credits for employers increasing employment in Indian enterprise zones, an investment credit for certain investments in Indian enterprise zone property, an exclusion from gross income for certain Indian enterprise zone capital gains, and exemptions from certain limitations on tax-exempt financing.

S. 983, which deals with rural enterprise zones, would aid designated rural areas also through the use of an employment credit related to increased employment. It would provide for a deferral of gain on the sale or exchange of enterprise zone property and an exemption from certain limitations on tax-exempt financing.

The revenue costs and structure of Federal tax incentives included in a proposed enterprise zone program must be evaluated in light of the impressive reforms enacted in the Tax Reform Act of 1986. The discussion that follows focuses on general concerns that would apply to any new enterprise zone proposal.

The Administration's own prior enterprise zone proposals contained provisions which are similar to those proposed in the current bills and was estimated to cost about $1.5 billion for the first three years. The Administration's program was proposed prior to enactment of the 1986 Act. Certain changes enacted under the 1986 Act would increase the revenue cost of certain incentives—such as the capital gains exclusion. At the same time, the 1986 reforms would reduce the revenue cost associated with other proposed incentives, such as certain tax credits.

The objective of providing Federal incentives through the tax code can also come into conflict with other objectives or compromises contained in the 1986 Act. For instance, although capital gains are fully included in minimum taxable income under current law, an enterprise zone proposal could provide that capital gains earned in an enterprise zone are exempt from the minimum tax. Exempting these gains from minimum tax would increase the incentive effect of the proposal. At the same time, however, it could come somewhat into conflict with the Act's tougher minimum tax, which attempts to ensure that all taxpayers pay a minimum amount of Federal tax liability.

The 1986 Act also eliminated the investment tax credit for equipment and machinery. Low marginal rates, we concluded, are the most effective means of stimulating more investment, saving, and work effort. Economic distortions would be reintroduced by enacting investment credits for only certain types of human or physical capital as part of an enterprise zone program.

The 1986 Act also placed significant limitations on the use of tax-exempt bonds and private activity bonds. It should be considered at this point whether it is most appropriate for State and local government decisionmakers to determine which types of bonds are most needed in which communities. Thus, limitations on the use of small issue bonds to finance only manufacturing facilities might not be appropriate. However, the issue is relevant both if the total volume cap remains as it is at present levels, or if we would try to set it at some higher level.

In conclusion, the Administration continues to support the enterprise zone concept as a constructive approach for dealing with the problems of economically distressed areas. State and local governments already have shown the beneficial effects of removing burdens that inhibit economic activity in distressed areas. However, at the present time the realities of the Federal budget deficit must occupy a principal role in the shaping of a program to encourage efficient business development in economically distressed areas.

In addition, any proposal should take into account the current budget situation and the recent changes contained in the Tax Reform Act of 1986.

Senator BAUCUS. Thank you very much.

I am curious about two points. One, I am not clear on the revenue estimates the Treasury has for the enterprise zone bills, and also for the bill introduced by Senator Chafee, the Third World Debt Contribution Bill.

Mr. STEUERLE. Senator, we believe that the cost of these bills would probably be similar to the cost of the previous Administration proposal, which is about $1.5 billion. However, we have not redone those estimates to take into account the changes in the Tax Reform Act of 1986. So, it was $1.5 billion over three years.

Senator BAUCUS. That is 1.5. Is that for each of the two enterprise zone bills, or is that total for both the Indian and the rural enterprise zones?

Mr. STEUERLE. Senator, the cost that I am referring to is our estimate for a broad enterprise zone proposal for a certain number of designated areas. It would depend upon how many designated areas we had, how many were in Indian or rural areas, how many were in urban areas, if the Senate were to consider that at the same time. We have not reestimated the two bills in question here.

Senator BAUCUS. What about the Third World Debt Bill? Have you had a chance to review that?

Mr. STEUERLE. That is in another part of my testimony. Would you like me to go into that?

Senator BAUCUS. Yes. While you are here, you might as well proceed to that part.

Mr. STEUERLE. All right.

Persons who currently make contributions to religious, charitable, and educational organizations may, subject to certain limitations, claim a deduction for the charitable contribution. If the contribution is of property, the amount of the allowable charitable contribution deduction generally is equal to the fair market value of the property at the time of contribution. Thus, under existing rules, a taxpayer who contributes property having a fair market value that is less than the taxpayer's basis cannot deduct the excess of basis over fair market value as a charitable contribution deduction. In contrast, if the taxpayer sells or otherwise disposes of property, the taxpayer generally is allowed a loss deduction in an amount equal to the difference between the property's basis and its fair market value. If the taxpayer then contributes the proceeds to a charity, he can obtain the full benefit of its basis in the property, first by obtaining the loss deduction for the sale, and then by taking a charitable deduction for the donation.

The ability of taxpayers to obtain the full benefit of their basis in property by selling the property and contributing the proceeds is illustrated by Revenue Ruling 87-124, which was published by the Internal Revenue Service earlier this week. As you know, Senator, this revenue ruling came about in part as a response to the situation brought to you today by the World Wildlife Fund and other charitable organizations.

In one of the situations addressed in the ruling, a U.S. commercial bank transferred a debt instrument of the foreign country to the central bank of the foreign country and, in accordance with a prearranged plan, the central bank credited the account of a charitable organization with an amount of local currency. The ruling holds that the U.S. commercial bank is treated as if it had received the local currency from the central bank and then contributed the local currency to the charitable organization. Accordingly, the U.S. bank recognizes a deductible loss in an amount equal to the excess of its basis in the debt instrument over the fair market value of the local currency, and then may claim a charitable contribution deduction in an amount equal to the fair market value of the local currency.

Thus, the ruling is consistent with current law.

S. 1781 would amend section 170 of the Internal Revenue Code to provide that, in the case of a "qualified debt contribution," the amount of the otherwise allowable charitable contribution deduction will not be less than the donor's basis in the contributed debt instrument.

S. 1781 is intended to encourage the conversion of debt instruments issued by developing nations into funds that will be put into use in the debtor nation, and this goal of the bill is consistent with the Treasury Department's goal in its recent ruling.

Our recent analysis of issues relating to the contribution of debt to charitable organizations, however, has led us to conclude that the adoption of S. 1781 is not necessary to encourage the conversion of debt instruments into funds that will be put to use in the debtor nations. Moreover, we are concerned that S. 1781 as currently crafted could favor certain charitable organizations over others and, by improperly characterizing the deductions of the donor, produce possible tax distortions. For these reasons, we believe that the enactment of S. 1781 is unnecessary and that the Revenue Ruling is a more appropriate means to take care of this problem.

If the subcommittee concludes that the treatment of contributions of depreciated property should be revised, we suggest that certain aspects of S. 1781 be reconsidered.

First, while international conservation purposes are meritorious, there is no reason to favor a single type of charitable organization over other charitable, religious, and educational organizations.

Second, by characterizing the entire amount of the deduction allowable to the donor as a charitable contribution deduction, the bill provides taxpayers with possible tax avoidance opportunities in any situation in which the treatment of a charitable contribution deduction and a loss deduction may differ.

This concludes my prepared remarks.

[The prepared statement of Mr. Steuerle appears in the appendix.]

Senator BAUCUS. Thank you very much, Mr. Steuerle.

I have no further questions, except for the revenue loss. Will there be a revenue loss associated with the Treasury's posed ruling?

Mr. STEUERLE. Senator, this is one of the interesting and most difficult questions we have been trying to deal with. As you know, we have—as has this subcommittee—been trying to deal with this issue for some time.

Generally, if revenue rulings are consistent with current law, we do not issue revenue estimates. The reason for this is that the current law estimates are contained in a baseline. Our baseline estimates for current law treats rulings as interpretations of that law. Those interpretations facilitate certain actions in the economy. We still do not designate a revenue loss to it, just as if we were delaying regulations we could perhaps pick up revenues, because we would deny taxpayers the ability to engage in transactions. But we would not want to score such a delay as a revenue gain.

Accordingly, the revenue ruling itself does not entail any revenue loss. If you go towards legislation, however, and the legislation changes current law, then we do get into a scorekeeping problem, which is one of the reasons why we hope to resolve this issue in the context of rulings rather than legislation.

Senator BAUCUS. But what is the revenue effect of the bill? Has Treasury looked at that?

Mr. STEUERLE. We have not scored the revenue effect of the bill. However, we have concluded that a narrowly-crafted bill that would only cover certain charitable contributions to agencies like the World Wildlife Fund, or similar conservation organizations, would be negligible, simply because such a bill is designated only for a small number of organizations.

However, this raises another problem: We would save the revenue, but would be favoring one type of charitable organization over another.

Senator BAUCUS. Thank you.

Senator Danforth?

Senator DANFORTH. Could I pass for a minute, Mr. Chairman?

Senator BAUCUS. Sure.

Senator Chafee?

Senator CHAFEE. Mr. Chairman, we do have a letter from Secretary Baker dated June 25 on this particular matter, in which he says that we estimate the revenue cost of the proposal as negligible.

You are familiar with that?

Mr. STEUERLE. Yes, Senator Chafee. That is in conformity with my previous remarks.

Senator CHAFEE. Now, one of the points that you raised is that you have concerns that there might be an opportunity for tax avoidance here, because the donating taxpayer could choose to characterize the deduction as partly a charitable and partly a loss.

In conversations with the parties involved, which are some of the banks who would be potential donors of these debt instruments, they don't care how the allocation is made. In other words, if the Treasury Department wanted to suggest an amendment to the legislation or simply some report language to specify how you think the deduction should be characterized—in other words, what parts should be loss and what parts should be a charitable donation—that is something that is certainly acceptable.

Mr. STEUERLE. Senator, we have been trying to work very closely with them on exactly that point. We think our ruling solves that particular problem. What we are trying to do is to remain consistent with current law by simply allowing market valuation of the debt to determine the loss on the debt, and then allow the remainder of the contribution to be treated as a charitable contribution. That would be consistent with current law. That would not change the current treatment in any way, and this result would not permit gaming of the system.

Senator CHAFEE. Now, on the question of extending it to other charitable causes, that is no problem, either, if that is what you want to do.

Now, as to whether the revenue ruling makes the bill unnecessary, I think we will find some witnesses after you who would question that. I am not sure exactly on what basis.

Mr. STEUERLE. Senator, if I can, I can mention one of the problems here, if it might help to clarify those witnesses' concerns.

Senator CHAFEE. Yes.

Mr. STEUERLE. One of our concerns is that charitable contributions in the United States are allowable only for contributions to domestic charities. Among the concerns of some of these organizations is the extent to which we can ensure that these funds flow through domestic charities to meet the fiduciary standard that we require under current law by having them go through U.S. charities.

The difficulty was, again, trying to make a single exception for dollars that might flow directly to a foreign charity without going through the U.S. charity. Then we would be creating an exception to a broad provision of current law that charitable contributions can only be made to domestic organizations, even though such organizations operate abroad. I think some of the charitable organizations are concerned that in some of the countries the host government is not sure of the extent to which they do or do not want to have the U.S. charities involved in the transactions. Those are among the difficulties we are trying to work with U.S. charities to resolve.

Senator CHAFEE. Now we are getting into the structure of the arrangement, of the transaction. Under our bill, the debt would go—well, let us just take a case. The U.S. bank has some bonds from Costa Rica that cost $100 per bond, but let us say that the value of them now is $7. So, they give the bonds to a U.S. 501(c)(3) corporation, entity. And then that entity redeems these bonds with Costa

Rica. And then the money is used to buy the rain forest or the park land. Now, that is the way the setup is structured under our legislation.

In your ruling, the debt would go to the bank of a Third World country, which would then turn the money over to a 501(c)(3) corporation, right?

Mr. STEUERLE. That is correct, Senator.

Senator CHAFEE. Now, what are the problems with the way we had it structured in the bill?

Mr. STEUERLE. Well, Senator, the difficulty is that there is a current provision of the law: where there is a loss involved, the charitable contribution deduction is only allowable up to the market value of the contribution. If you make the contribution first, under current law, and it doesn't matter if we are talking simply with this particular case or about all types of charitable contributions, you only allow the deduction up to the fair market value of the transaction. Current law allows the taxpayer to get around that, essentially, by restructuring the transaction so the taxpayer sells the asset first, recognizes the loss, and then takes the charitable deduction.

The difficulty in the bill is that, if we try to rearrange it for this case only, we are again setting a narrow precedent for only one type of charitable organization. And if we don't specifically want to do that, if we want to go beyond that and establish it for all charitable contributions—that is, one would be allowed a deduction equal to the basis in the property—then we may be involved in some revenue losses clearly involving legislation; it is not something that is allowed under current law.

So, under current law, the way one is allowed to get the full deduction is essentially to take the loss first and then to make the charitable contribution.

Senator CHAFEE. My time is up, Mr. Chairman.

Senator BAUCUS. Go ahead, Senator Chafee.

Senator CHAFEE. I don't understand why your revenue ruling is okay, and the legislation isn't. That is where I get lost.

Mr. STEUERLE. Under current law, once you take a loss for the difference between basis and fair market value, and then take a charitable deduction, under current law one cannot take a charitable deduction if one gives away the property for the basis in the property. That is true for all properties.

So, by giving the money away first, by making the charitable contribution first, you run into what really is a dilemma for the organizations involved.

Senator CHAFEE. But we don't lose any more under our bill than we would under your revenue ruling.

Mr. STEUERLE. The reason you don't lose much more under your bill, Senator, is because your bill is narrowly crafted to deal with only these particular types of charitable organizations. Our problem is that, if we want to allow a charitable deduction for basis in property, we have some problems with only allowing that for a particular situation. We would want to, then, consider whether we would want to allow a charitable deduction for all properties in which there is a loss. And if we get into that, establish the rule on a broader scale, then we would be involved in some sort of a revenue loss.

Senator CHAFEE. Senator Danforth has some questions.

Senator BAUCUS. Thank you, Senator.

Senator Danforth?

Mr. STEUERLE. Senator, let me just say that we are both really trying to resolve this problem. We are trying to do it in a manner, as best as we can, that is consistent with current law and does not involve a revenue loss that may derail the whole project.

Senator DANFORTH. Mr. Secretary, a question on rural enterprise zones. I am sorry that I was just coming back from the floor of the Senate when you testified, but I am told that you estimate that the cost of the rural enterprise zone legislation would be one and a half billion dollars over three years, is that right?

Mr. STEUERLE. No, Senator. For the record, let me correct my statement. What I stated was that the legislation for both rural and Indian enterprise zones was crafted similarly to the previous legislation proposed by this Administration, which had a designated number of enterprise zones. That legislation was estimated, in 1986, as costing $1.5 billion over three years. That is the only current estimate we have. That is not meant to be an estimate of your particular bill.

Senator DANFORTH. Right. That was $1.5 billion over three years for a bill that provided, I think, was it 100 enterprise zones, some rural, some urban?

Mr. STEUERLE. Seventy-five.

Senator DANFORTH. And so that was $1.5 billion for 75 enterprise zones. Some of those were urban, weren't they?

Mr. STEUERLE. That is correct.

Senator DANFORTH. How many were urban?

Mr. STEUERLE. I don't believe we separated out how many had to be urban versus rural.

Senator DANFORTH. But in making an estimate, you would have to guess the cost. Wouldn't you estimate the cost on the average for an enterprise zone? Wouldn't the cost of an urban enterprise zone likely be higher?

Mr. STEUERLE. It would depend upon whether we thought there were more tax-exempt bonds being used in one type of enterprise zone versus another, more credits, more people employed. It would not necessarily be higher.

Senator DANFORTH. But you don't think that this bill would cost anything like $1.5 billion over three years, do you?

Mr. STEUERLE. No, Senator. Again, it depends on several factors, including the number of enterprise zones involved, and the number of credits.

Senator DANFORTH. We are talking about 45 with a maximum of 18 in any year.

Mr. STEUERLE. That is correct. And Senator, in your bill you also made special efforts to reduce revenue costs, for example, by not offering an exclusion of capital gains but by offering a deferral of capital gains. And that would also save on the revenue cost.

Senator DANFORTH. So it would be reasonable to believe that the cost would be very considerably less than $1.5 billion over the three years?

Mr. STEUERLE. I believe that is correct, Senator Danforth. Yes. We simply have not had a chance to reestimate these proposals.

Senator DANFORTH. In making your revenue estimates on this kind of issue, are your estimates static estimates or do they build into them economic reflows?

Mr. STEUERLE. Senator, the estimates, as are all revenue estimates, are static in the sense that that we do not assume any increase in GNP or employment in the economy. They are not static, however, because we do assume behavioral changes on the part of taxpayers with regard to how they might invest and where they might be employed.

The reason we are constrained to give estimates on the basis of a given level of GNP is that that is how we operate on the entire side of the budget.

As you know, even for other proposals the Administration favors, such as tax reform, we also did not estimate a reflow back to the economy. We stated we thought there would be substantial reflow. We thought that we would have substantial improvements in the economy. But we did not put that additional revenue into our estimates, whether they are estimates of proposals we favor or estimates of proposals we disfavor.

Senator DANFORTH. Has the Administration taken a position for or against the rural enterprise zone bill?

Mr. STEUERLE. Senator, our position is that we have favored and continue to favor the enterprise zone concept. Our only constraint right now is that we are in the midst of budget negotiations and are not prepared to make proposals outside of that context.

Senator DANFORTH. But the Administration continues to feel that the concept is a good concept?

Mr. STEUERLE. That is correct, Senator.

Senator DANFORTH. Thank you.

Senator BAUCUS. Mr. Secretary, why under the Treasury ruling would debt be donated to a bank, the central bank in the Third World debt country? What is the requirement and what is the rationale for the requirement under the Treasury's ruling that the debt be donated to a central bank?

Mr. STEUERLE. The debt is exchanged at the central bank. I think we are basically involved with just trying to ensure—we have a measurement problem as well. We have to determine what is the market value of the debt, and you need some intermediary to establish the exchange rate at which you are willing to make the conversion.

Senator BAUCUS. Would the banks tend to favor the approach of Senator Chafee, insofar as the banks don't like to show losses?

Mr. STEUERLE. Senator, we recognize that there is a constraint which is independent of either the bill or the ruling, the extent to which banks are going to recognize losses. In some cases they are engaged in serious negotiations with host governments. Those negotiations sometimes involve arguing over what the value of the debt is and what banks can exchange it for. And certainly this type of ruling or this type of bill is not going to avoid that problem.

Senator BAUCUS. Thank you.

Senator Chafee, do you have any more questions?

Senator **Chafee**. There is one question I would like to ask. Just going over the structure once again, in the bill it provides that debt goes to a 501(c)(3), and then it gets to the park. Under yours, the debt goes to a Third World bank, and then they give to a 501(c)(3) corporation.

Mr. **Steuerle**. The Third World bank is involved mainly to have somebody who buys the debt so the loss is recognized first.

Senator **Chafee**. That is right. Then the theory is that the central bank of, let us say, Costa Rica would then under the deal give it to say the World Wildlife Fund, which is a U.S. 501(c)(3), right?

Mr. **Steuerle**. That is correct.

Senator **Chafee**. Okay. Now, the problem there is, I suspect, that it is a little difficult for the bank, the Central Bank of Costa Rica or whoever it might be, to give away money to a U.S. charity. I mean, that presents political problems within the country itself: "What are you doing this for?"

And yet, it is only valid if it does go to a U.S. charitable corporation. So we have a politically sensitive problem, I would suspect, there.

So I really liked the suggestion we had in the beginning better. Could you tell me briefly what is the matter with the proposal?

Mr. **Steuerle**. Senator, again, our purpose in the ruling was to try to provide a mechanism where hopefully all of these transactions would take place almost at the same point in time, but for legal purposes would take place one after the other so we would recognize the loss before the charitable contribution was made.

Again, under current law for any contribution of a loss asset there is allowed only a deduction equal to the market value.

Senator **Chafee**. Yes, you said that, and we know that. Go ahead from there.

Mr. **Steuerle**. In your bill, if one has the contribution go to a charitable organization first, you face the horns of a dilemma. Either (a) you abide by current law and you only allow a loss for the basis, and that is not what you want because then the incentive is gone—I'm sorry, you only allow a loss for the market value. Or (b) you allow a loss for the full basis, which is what you attempt to do in your bill. But then you have set aside particular charitable organizations to have an exception from current law, as opposed to applying it to all charitable organizations or all contributions of loss property.

Senator **Chafee**. Well, the problem I don't get is, if the bank wanted to sell it and give away the money, they would have everything that you are objecting to. They would have the loss and they would have the charitable contribution, so they would be able to deduct 100 percent, right?

Mr. **Steuerle**. Right.

Senator **Chafee**. Right.

Mr. **Steuerle**. Okay.

Senator **Chafee**. So, what we have done in this bill is to let them again get both, but not go through quite that process. So they get the total from their basis, they get the total deduction. You are objecting to that?

Mr. **Steuerle**. No. We are trying to reach the same result. We were trying to reach exactly the same result of allowing the full deduction to be taken.

Under the bill there is no recognition event for determining the loss itself. We are trying to establish a recognition event, an event which allows the transaction to take place so we know the value of the loss, and we know the value of the charitable deduction.

Senator **Chafee**. Does it make that much difference which is the loss and which is the charitable deduction? As long as you can't go above the total, can't go above your basis?

Mr. **Steuerle**. For those purposes it doesn't; for some purposes it does. Among the reasons it makes a difference is that there are sourcing rules as to whether a deduction is foreign or domestic. There are also limitations on charitable deductions that apply to taxpayers. Again, if we allow an exception for one type of taxpayer, why do we not allow it for another?

Senator **Chafee**. Well, we prevailed on the Chairman's time; although this is a problem that accountants are dealing with all the time. There is nothing unique about determining what is a loss and what is a contribution for the foreign sourcing purposes. So, I don't think that should be such a major stumbling block.

However, my view is don't insult the crocodile until you cross the stream. So I am anxious to stay on your good side until we get this accomplished.

Mr. **Steuerle**. Well, Senator, we are anxious to stay on your good side, too. I think we are both aiming to achieve exactly the same result, and we are just trying to find the best means for getting there.

Senator **Chafee**. Well, I am thrilled that you want to stay on my good side, and I have some suggestions for how you might do it. [Laughter.]

Thank you very much. I have some questions that I would ask that you answer at your leisure.

Senator **Baucus**. Thank you very much, Mr. Secretary, for your help.

Senator **Chafee**. Thank you very much.

Senator **Baucus**. Our next witnesses are on a panel of four. They are the Honorable Peter McDonald, Chairman of the Navajo Tribal Council in Window Rock, Arizona; Dr. Charles Pace, Director of Economic Analysis, Shoshone-Bannock Tribes, Fort Hall, Idaho; Mr. Oleg Cassini, President, Oleg Cassini, Incorporated, New York, New York; and Mr. Tom Mulvaney, Vice President and General Counsel, CP National Corporation, San Francisco, California.

Gentlemen, why don't you proceed in the order in which I introduced you. Chairman McDonald, why don't you begin first?

STATEMENT OF HON. PETER McDONALD, CHAIRMAN, NAVAJO TRIBAL COUNCIL, WINDOW ROCK, AZ

Chairman **McDonald**. Mr. Chairman and members of the subcommittee, it gives me a great deal of pleasure to be here this morning and to testify on Senate Bill 788, the Indian Economic Development Act.

Before I do that, though, if I may, Mr. Chairman, Senator DeConcini of Arizona asked me to submit his statement for the record as an expression of his support for Senator McCain's bill, S. 788.

Senator BAUCUS. Without objection it will be included.

Chairman MCDONALD. Okay. I will just leave that there. And he does say that he strongly supports the colleagues' bill S. 788.

My name is Peter McDonald. I am Chairman of the nation's largest Indian tribe, the Navajo Nation. One out of every Reservation-based Native American is Navajo. The average age of a Navajo is 18 years of age. Fully half of our population is under 21 years of age, and we are growing at the rate of three percent, net, per year.

According to the 1980 Census, the average per capita income on the Navajo Reservation was $2,004 per year. This was approximately one-third that of the surrounding States. Our official unemployment rate on a Navajo Reservation varies between 33 percent all the way up to 60 percent, depending on what parts of the Reservation you are making a survey.

I have an extended testimony which I would also like to submit for the record, Mr. Chairman, and I will just summarize it here briefly, what is in the statement.

Senator BAUCUS. I might say to each of the witnesses that, for each of the witnesses, your entire statement will be in the record. Also, I encourage each of you to summarize your statements.

Go ahead.

Chairman MCDONALD. As I have said, the Navajo is the largest Indian tribe in America: Over 200,000 in membership, increasing at a record rate, like three percent, net, per year, which means that close to 3,000 people are added to the population every year. And also we have high unemployment. We have a labor force of close to 100,000 Navajos, and nearly 50,000 of those are now without jobs, at a very young age, the median age of around 18 years of age. They all want to go to work.

We have young people going to school. We encourage them to go to school and get an education, to go after career opportunities, and when they do get a college degree or get trained someplace else, they come back to the Reservation. They want to go to work but are unable to find jobs on Reservations, so they must leave, or succumb to alcoholism, drugs, suicides, and what have you.

These circumstances are very shameful. To address them, we have one option: To create a thriving Reservation-based private sector capable of creating at least—this is our goal—1,000 new jobs per year. That is what our target is, while contributing to the development of our infrastructure, health care improvement, and quality in housing and education.

The alternatives are continued struggle with alcoholism and the loss of our best and brightest from the Reservation. The legislation we are discussing here today can be a powerful catalyst for attracting the private sector to Indian Reservations.

Senator McCain is to be congratulated for having the foresight to recognize that tribal governments require special incentives if they are to be able to compete on a more level playing field with States and foreign countries for industries.

There are those who will ask why tribes alone deserve such legislation to become competitive, while others will question whether it is appropriate to open up the tax code after last year's tax reform. Others may question the bill's revenue neutrality.

My response is simply this: To end the poverty and unemployment on Indian lands, we must develop a Reservation based private sector capable of providing employment opportunities for tribal members. Federal tax incentives must be offered to companies willing to locate on Reservations. The reason for this is simple: At this stage in our development we cannot yet offer the amenities to the private sector that companies take for granted when negotiating with States all around us. I am speaking of such requisites as a developed infrastructure, adequate housing and health care, and a skilled and educated workforce.

When a corporation calculates its investment decisions, all of these elements are figured into their equation. Without the tax incentives included in the Indian Economic Development Act, the Navajo Nation and many other Native Americans throughout the country face many competitive disadvantages. This legislation will allow Indian tribes to compete more fairly with States and foreign countries on a more level playing field for investment and jobs.

States and cities, as we have just heard here from the Senator from Missouri, have these incentive programs, enterprise zones; but not on the Indian Reservations. Why? Why are Indian Reservations like islands with no development for over a hundred-year period?

Well, you may blame the Indians for this; but, nevertheless, who is running the Reservations today and for the past hundred years? The United States Federal Government through the Bureau of Indian Affairs. They have failed miserably to allow the private sector to develop on Reservations.

Yet, today we all believe in the private sector. That is America, free enterprise. We don't have it on Reservations, and that is the reason we believe it is important that this legislation be provided, so that Indian tribes will come up to speed and be equal to all other areas around the Reservations. So, it is important that we continue to address the needs of the Indians in this way; because, as I said, there is no development. There are no factories on the Reservations, no shopping centers, no stores, no neighborhood organizations. Yet, the total Indian population today is over a million, and almost half of those people need jobs, are now without jobs, and are succumbing to alcoholism, drug abuse, and the suicide rate on Reservations is very, very high.

Senator BAUCUS. Thank you. I will have to ask you to summarize your testimony.

Chairman MCDONALD. Okay. Well, then, I would just like to also respond to the Treasury's concern that somehow this particular legislation should be deferred.

Senator BAUCUS. I am going to have to hold all witnesses to the five-minute rule. So if you could make your final statement in a couple of sentences, I would appreciate it.

Chairman MCDONALD. Okay.

All I can say is that we cannot defer helping people who are hungry, who are heavily addicted to alcoholism and drug abuse, because they cannot find work. We must find a solution, because this is America.

[The prepared statement of Mr. McDonald appears in the appendix.]

Senator BAUCUS. Thank you, Mr. McDonald.

Dr. Pace?

STATEMENT OF DR. CHARLES PACE, DIRECTOR, ECONOMIC ANALYSIS, SHOSHONE-BANNOCK TRIBES, FORT HALL, ID

Dr. PACE. Thank you, Mr. Chairman.

I will try to be brief, and I will summarize my remarks. I look a lot at the technical dimension; but this morning when Senator McCain was speaking, the human dimension struck me as the thing to talk about today, because there is an urgent need for economic development.

With the people I work for, in certain areas of the Reservation the latest statistics indicate 70 percent unemployment. On the Reservation almost half of the households live below the poverty line. I think it is something like 46 percent. Unemployment, Reservation-wide, is well in excess of 30 percent.

But the thing that is really not there is the hope. This legislation and I think the creation of employment opportunities and training, entrepreneurial opportunities, will provide the Indian people who are living on the Fort Hall Indian Reservation, at least, with hope that they don't have now, hope that their children can grow up and be meaningfully employed, that they can contribute to society, that they won't be disenfranchised.

The legislation is not a panacea. We strongly support it but it is not a panacea; it stops short of what we would like to see and what was recommended in the Presidential Commission and the Indian Task Force. There are other things that can be done and that the tribes are doing right now. One is enacting business codes, setting up a stable environment, building up tribal courts, and so on, so that people know when they come on the Reservation that there are rules of the game and, as Senator McCain said, that they won't be subject to the vagaries of tribal government; although, I would say that I think that is a misimpression—I think tribal government is good government. The problem is educating people about the process.

The gentleman from the Treasury expressed concern about the deficit. We, too, are concerned with the deficit. Idaho is a resource State, and Fort Hall is a resource Reservation. We have been devastated by the continuing deficits and recession since 1979. Idaho has never recovered. We are very early in the production chain; we are the first to suffer and the very last to recover—something that I think the people from Missouri also experienced. And the Federal Reserve policy of using high interest rates to attract foreign investors into dollar-denominated assets to finance the Treasury's appetite for funds has even worked against us. It has destroyed the markets for the products that we have, and it has encouraged foreign competition.

But at the same time, the gentleman from the Treasury was looking at the overall picture. I think when you look at Indian economic development zones, it is unlikely that there will be a major drain on the Treasury. Indian Reservations in general are subject to tremendous leakages off Reservations. So, even if we are talking about new businesses locating on the Reservation, most of that money is going to be disbursed back into the wider economy and probably will very rapidly find its way into the regional and the money center areas.

On private activity bonds, we think that that is also important. We think that this tool can establish an economic base for tribes. Allowing tribes to issue private activity bonds will also remove a lot of uncertainty that now surrounds the tax status of tribally-issued securities. We know there are movements in the House to curtail tribes' abilities; we are concerned about that. We know there is also activity between the Treasury and the BIA to clarify the kinds of essential governmental functions that qualify for tax-exempt issues. But we think private activity bonds are very attractive as a way of increasing a tribe's economic base, that you can combine the tribal interests with widespread public interests, and that Indian and non-Indian people will benefit without major impacts on Treasury revenues.

Thank you.

[The prepared statement of Dr. Pace appears in the appendix.]

Senator BAUCUS. Thank you, Dr. Pace.

Mr. Cassini?

STATEMENT BY OLEG CASSINI, PRESIDENT, OLEG CASSINI, INC., NEW YORK, NY

Mr. CASSINI. Thank you, Mr. Chairman, Senators.

I would like to take one minute to try to convince the committee that I am a bona fide, knowledgeable person in the subject. I have been interested in Indian history and affairs for a great many years, more than 50, and in this particular connection all my interests for the Indian that had been 30 years ago kind of blunted, because when I tried to reach some solution and help particularly the Navajos, because they are the largest and most significant group of Indians at this point, I went to see the President of the United States, Kennedy and his brothers, and I talked about the Indian situation, I had a feeling that they knew less than I was hoping and that that is prevalent in the United States.

There are many people who have a very small recollection of the Indian wars, the Indian history, practically the elimination of the Navajos from this earth, and maybe they would have been luckier if the 7,000 had not come out of that march, because what I see today is so devastating, so terrible, that I think maybe they should have disappeared from this earth. It would have been much better, maybe.

So when I talked to the President, he was kind enough to even mention that maybe I would have been a good man for the Indian Bureau. Maybe it was facetious, but anyway he knew how deeply I was involved with this cause.

Then, I gave up, sort of, because I realized that there was no way, that bureaucracy made it impossible for people who wanted to do quick business. Thirty years ago, the Indians, the Navajo, were still wards, and what really happened is that now, 30 years later by a chance destiny I met a great leader of the Indians, Chairman

McDonald, a man that I respect and admire, and who I think might be a savior of the Navajos. I decided to do everything I could to help him to articulate what I thought were some of the needs, the human needs—as you said so well, and I was going to bring some of the things you said out.

It is a drama. This is a very, very generous nation, and it takes care of a lot of people all over the world. I think it would be appropriate for Americans to consider the plight of these Indians. I think it is a must, because when I went for the last time in the summer to the Reservation, I talked to many of the Indians. My impression was that there was a catastrophic mood, that anything dramatic could happen, any time, and 200,000 people left there without hope are dangerous in the heartland of America.

So I am here now to hope that this will pass. This legislation is so important. It would be a step. My experience in business teaches me that businessmen are bottom-line people, and they want to see what they can do successfully with a business.

There is nothing that the Navajos can offer today in competition with Taiwan, Korea, and other countries. But they have an artisanal flair, they have a great talent, and they could easily have helped produce the kind of competitive merchandise the world at large would like.

I don't know if I have omitted something, but I am very grateful to you for accepting my few words. Thank you very much, Mr. Chairman.

[The prepared statement of Mr. Cassini appears in the appendix.]

Senator BAUCUS. Thank you, Mr. Cassini.

The final witness is Mr. Mulvaney.

STATEMENT BY TOM MULVANEY, VICE PRESIDENT AND GENERAL COUNSEL, CP NATIONAL CORP., SAN FRANCISCO, CA

Mr. MULVANEY. I am here this morning to address the Indian Economic Development Act of 1987, Senate Bill 788.

Mr. Chairman, Senator, Phillip, panel members, and guests: My name is Tom Mulvaney. I am Vice President and General Counsel of CP National Corporation, based in San Francisco, California. CP National's chairman and chief executive, Ben Agee, sends his regards to all of you today. He couldn't be here because of prior commitments.

CP National Corporation is a diversified communications, energy, and manufacturing enterprise with operations in 11 States within the United States of America. Through these operations we expect to generate approximately $250 million of revenue in 1987.

Our company is organized into three basic segments—we have a communications segment, an energy segment, and a manufacturing segment. Today I would like to talk to you about the communications segment and the Navajo Nation.

CP National Corporation is firmly committed to the Navajo people. Through Navajo Communications Company, CP National furnishes telecommunications services to the Nation. It provides local telephone, CATV, two-way radio service, as well as more sophisticated voice and data services to the communities and business within the Navajo Nation.

CP National believes first and foremost in the Navajo people. To show CP National's level of commitment to the Navajo Nation, its Chairman Ben Agee has agreed to serve as a member of the Navajo Nation Business Development Task Force that was created by Chairman McDonald. This is a group of business leaders who have committed to being surrogate recruiters for the Navajo Nation.

Mr. Agee is impressed with the Navajo Tribal Government's efforts to enhance the business environment on the Navajo Nation.

A sustained effort on the part of the Tribal Government to improve the business environment, coupled with the passage of the Indian Economic Development Act of 1987, will provide the Navajo Nation Business Development Task Force and the Navajo Nation with the tools they need to attract and enhance new and existing businesses.

CP National offers two perspectives today concerning Senate Bill 788. The first perspective emanates from its experience of conducting business and assisting in the creation of an infrastructure on the Navajo Nation conducive to commercial enterprise. The second perspective offers some generic perceptions relative to present and future commercial enterprises on the Navajo Nation and Senate Bill 788. Let us start with the first perspective.

Since 1970, Navajo Communications Company, or NCC, has supplied telephone service to the Nation. Today, approximately 10,000 Navajo people and businesses receive their services from NCC. Both Mr. Agee and Roy Kirkorian, CP National's President and Chief Operating Officer, have firmly committed NCC to the task of supplying the telecommunications service necessary to promote the development of the Navajo Nation's commercial infrastructure.

Telecommunications development in any environment requires major capital investment. While CP National is committed to making these investments, its future investment on the Navajo Nation would be facilitated in several ways by the passage of the Indian Economic Development Act of 1987.

One, the incentives offered within the Bill, including employment credits and investment credits, will attract other commercial enterprises to the Navajo Nation as well as assist in the expansion of existing business enterprises.

Two, the expansion of the Nation's commercial base will stimulate and grow the local economy. This growth, as well as the provisions of this bill, will facilitate additional capital expenditures by NCC in order to keep its system and service on the cutting edge of telecommunications technology.

Three, as a result of these capital improvements, the Navajo Nation's telecommunications infrastructure will continue to be enhanced.

As a company currently doing business on the Navajo Nation, CP National urges you to recommend passage of Senate Bill 788 to the full Senate Finance Committee.

Our second perspective is offered as a present and perhaps doing some future business as a commercial enterprise on the Navajo Nation.

I want to ask a question, and that is, what does a commercial enterprise that is an individual entrepreneur, a partnership, or a corporation consider prior to deciding whether it will make a personal investment of funds to establish or expand a business on the Navajo Nation or on any Indian land?

Normally, a business entity will examine several geographic areas and compare and contrast the potential labor force, business environment, and the commercial infrastructure before arriving at a decision whether to locate or expand within a particular geographic area. There is substantial competition, as has been mentioned this morning, to attract and retain business between various geographic areas within the United States of America.

If the Navajo Nation is to compare favorably and compete with State and local governments in terms of a favorable business environment and responsive commercial infrastructure, the Indian Economic Development Act of 1987 must be adopted.

The incentives contained in Senate Bill 788 and the Navajo Tribal Government's effort, combined, will enhance the Navajo Nation's business environment and aid in providing the necessary infrastructure to allow the Navajo Nation to compare and compete favorably with non-reservation areas.

In conclusion, I would like to say that CP National is most pleased to be a part of the record of the Indian Economic Development Act of 1987. CP National strongly thanks you for the opportunity to present its views and strongly urges you to recommend passage of Senate Bill 788.

Thank you.

[The prepared statement of Mr. Mulvaney appears in the appendix.]

Senator Baucus. Thank you, Mr. Mulvaney.

Gentlemen, I would like to know which of the various array of incentives in the bills makes the most difference to businesses. Where will a tribe get the most bang for the buck—that is, are they the credits for wages, or the nonrecognition of gain for the transfer of capital assets, or the securities treatment? I am just curious about which makes the most difference to the location and settlement of a business on the Navajo or any other Reservation.

Dr. Pace.

Dr. Pace. Mr. Baucus, I think the investment tax credit would bring unprecedented amounts of working capital on the Reservation, and combined with the pool of unemployed labor, that is significant.

The capital gains, in terms of poverty and unemployment, I am not sure what effect that would have. It is an incentive and a useful tool; but as far as a direct impact, the credits for economically disadvantaged individuals are keyed directly to tribal members. And the employment.

The other thing that I think is significant, we are spending a lot of time here on Federal incentives, but there also is a certain prescribed course of action for the tribal governments in terms of streamlining regulations.

What we have found at Fort Hall when we worked on streamlining governance is that we actually identified a lot more opportunities, too. So, those tribal activities beyond just the reduction of the tax rate, but setting up a stable business environment, that seems very important.

Senator BAUCUS. Chairman McDonald?

Chairman McDONALD. Mr. Chairman, I would just like to say that, from the tribal perspective, also, the ability to issue industrial development bonds is very, very important. We don't have that at the present time, so that becomes a real problem for us.

Also, what is included in the bill right now is the employment credit. I think that has a real possibility in terms of making sure that the employment generated on the Reservation provides employment for those who are presently unemployed on the Reservation.

Senator BAUCUS. Mr. Mulvaney?

Mr. MULVANEY. I would like to say something, too, to kind of amplify what Chairman McDonald was saying: CP National Corporation has made a commitment to the Navajo Nation to try to seek and increase the percentage of Native Americans that we employ, and the employment credits would be very important in helping us achieve that goal. We currently have 87 percent of our work force who are Native Americans at Navajo Communications. And also, the investment tax credits would be important to CP National Corporation.

Senator BAUCUS. Do these incentives, though, tend to make a greater difference to larger corporations, larger companies, than they do to small business, startup business?

Mr. MULVANEY. Speaking for CP National Corporation, we aren't a real big enterprise. It would be important to us. I think, though, that any business that is going into business is assuming they are going to make money; so I think it is the incentive. And the nature of it is very important, but I think it is the incentive that is important to attract businesses onto Indian lands.

Senator BAUCUS. Senator Danforth?

Senator DANFORTH. No questions, Mr. Chairman.

Senator BAUCUS. Thank you all very much. I appreciate your help.

Our next panel consists of Mr. Jack Stokvis, who is General Deputy Assistant Secretary for Community Planning and Development at the Department of Housing and Urban Development; Mr. Frank Swain, Chief Counsel for Advocacy for the SBA; Dr. Richard McHugh, Director of the Office of Research at the University of Missouri; and finally, Mr. Dennis Roedemeier, the President of the Cuba Industrial Development Authority in Cuba, Missouri.

Senator DANFORTH. Mr. Chairman, it is my understanding that Dr. McHugh has a 12:20 plane that he would like to catch, and I wonder if it would be all right if he could be taken first and if his questions could be asked before the rest of the questions.

Senator BAUCUS. Sure.

Dr. McHugh, why don't you proceed and say what you want to say, so you can catch your plane?

STATEMENT BY DR. RICHARD McHUGH, DIRECTOR, OFFICE OF RESEARCH, REGIONAL ECONOMIC DEVELOPMENT, UNIVERSITY OF MISSOURI, COLUMBIA, MO

Dr. McHUGH. First of all, thanks for the opportunity to testify here, and also thanks for the opportunity to get out in a hurry.

I will, naturally, be very quick. First of all, I do want to say that I would urge you to give serious consideration to the Rural Enterprise Zone Act of 1987. I don't think I need to amplify any more on the problems experienced in the rural areas. The question is not, is there a problem, but what if anything to do about it? This bill proposes a number of tax and financial incentives. The question is, will these tax and financial incentives work?

Earlier today we heard Senator Bond talk about the experience of Missouri when he was in office, and you will hear other evidence here about what has happened in Cuba and Macon, Missouri, and places like that. So there is plenty of anecdotal evidence. The problem is, as an economist, we are taught not to make decisions purely on anecdotal evidence and to look more carefully at the totality of the evidence.

The sort of inherited conventional wisdom in the last 10 or 15 years has been these types of incentives, if they do work, have been weak.

The principal thing I wanted to say today was that there has been a lot of work done recently in the economics literature on the effects of these economic incentives, and all of the work recently shows that these incentives had worked in the past and are working very well right now, as the anecodotal evidence seems to indicate, and that the strength of these policy initiatives is growing over time.

Now, the question is: Is this increased sensitivity just another statistical fluke—again, the result of some shoddy statistical work by economists? Or is there really some reason to think that all of a sudden these incentives would be more important than they had been in the past?

I would like to say I think there is plenty of evidence to think that now, in the mid-1980s as opposed to the sixties and the seventies, these incentives would be very important. On the one hand, in 1982 we had a very deep recession. The incredible competition from foreign manufacturers really put the squeeze on manufacturers and made them look for every cost advantage that they could possibly get. So, on the "demand side," as we like to say, there was an increase in the degree to which manufacturers would look at tax, financial, and cost advantages as were offered by State and local governments.

On the "supply side," again, as we would say, we had State and local governments which suffered financially and economically from the recession of 1982 and from the cutbacks in grants-in-aid that made these governments offer increased incentives. So we had sort of a meeting of the demanders for these financial incentives and the suppliers of the financial incentives. The result was a matching of the needs of the businesses and the desires of the governments to provide these incentives. It is now a standard part of the location decision. Businesses need to be given those. They expect and they want to be given the incentives to locate in areas. If not offered those incentives, they are very likely to look negatively at an area.

So, there is reason to expect that there would be an increased incentive to locate. And, as I said, the evidence is increasingly showing that these incentives are necessary.

I think a bill such as the Rural Enterprise Zone Act of 1987 would put the more depressed, hard-up areas on a more equal footing in the bidding for these industries. As it now stands, their resource base is disappearing, and they need everything that they can do in order to attract industries.

There is plenty more in the testimony that I have submitted, but I will just stop right now in the interest of time.

[The prepared statement of Dr. McHugh appears in the appendix.]

Senator BAUCUS. Thank you, Dr. McHugh.

Do any others of you have planes to catch?

[No response.]

Senator BAUCUS. Okay. Let us go down the list.

Senator DANFORTH. Dr. McHugh, I know you are on your way to the airport, but could I just ask one question?

Senator BAUCUS. He is your Senator; you had better stay.

Senator DANFORTH. No, no—quite the contrary.

You say that the evidence is that rural enterprise zones work. The evidence pertains only to the State enterprise zones, and you extrapolate from the experience with State enterprise zones that Federal enterprise zones would be an added incentive, or an equal incentive, or that it would have a multiplier effect?

Dr. McHUGH. The evidence that I cited is more general. Incentives of any kind, in any area, now appear to be worthwhile. They do have an effect.

The evidence that I cite is not simply rural, State-run enterprise zones but any kind of tax incentives at all to influence the location of economic activity. It is shown to have a very strong effect.

Senator DANFORTH. And you have no doubt that if this legislation were passed it would be of very real assistance to those communities that became enterprise zones?

Dr. McHUGH. There would definitely be some benefit, within a 95-percent confidence interval, as we say—a strong probability that it would help.

Senator DANFORTH. One final question. Say there is a rural enterprise zone in say Cuba, Missouri. Does that mean that a community that is not an enterprise zone is disadvantaged? In other words, say that there is a close-by community, say Union, Missouri. Would that be disadvantaged by Cuba having an enterprise zone?

Dr. McHUGH. Well, you necessarily must pick one area over another. But I think this whole story of robbing Peter to pay Paul can be exaggerated; it is too simplistic a view of what goes on.

A lot of times—in fact, most of the time—growth in one area relative to the other isn't because of the decision of a plant to pick up and move to another area. I know instances in Missouri in which one particular company faced the decision to close one plant or another plant and chose to keep the plant open in the enterprise zone. So, it is not simply a matter of taking from one to give to another.

Senator DANFORTH. Well, it is also possible that businesses in other countries could locate an a Missouri community.

Dr. McHUGH. That is certainly true.

Senator DANFORTH. Senator Bond just returned from Korea. A few years ago I was in Korea talking to businesses about the possibility of locating in smaller communities in our State. When we have a global economy, it makes it more likely that businesses that otherwise might be located in some other part of the world would locate in our country.

Dr. McHugh. Some foreign manufacturers would come into the country looking for a place to locate. And the rural enterprise zone designation is a flag right away that this is an area in which there is going to be a lot of attention paid and really wants to grow. So, if nothing else, it is a signal that this is a community where these places should look.

Senator Danforth. Catch the plane.

Dr. McHugh. Thank you.

Senator Danforth. Thank you.

Senator Baucus. Thank you, Dr. McHugh.

Mr. Jack Stokvis, why don't you proceed next?

STATEMENT BY JACK R. STOKVIS, GENERAL DEPUTY ASSISTANT SECRETARY FOR COMMUNITY PLANNING AND DEVELOPMENT, DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT, WASHINGTON, DC

Mr. Stokvis. Thank you, Mr. Chairman.

I, too, greatly appreciate the opportunity to address the committee, and in the interest of time I will keep my remarks brief and will submit them for the record.

My office, the Office of Community Planning and Development at HUD, has the lead responsibility for Enterprise Zones within the Department. As you know, Federal Enterprise Zone legislation has been a leading goal of both President Reagan and Secretary Pierce since 1982. We commend Senator Danforth for his long-standing interest in this concept, and particularly his consistent championing of the special concerns of rural areas, especially in Missouri. We also commend Senator Chafee for his long-standing support of the Enterprise Zone concept.

My testimony covers three areas: Observations regarding the State Enterprise Zone experience, which HUD has been coordinating and monitoring; comments on the bill, S. 983; and HUD's plans for implementation if the bill should be enacted.

The State Enterprise Zone experience has been rich and varied since the first States started their own programs in 1982. Also, as you know, though it hasn't been stated here, the whole concept of Enterprise Zones itself is an import from abroad, particularly from Great Britain. I think that it has found fertile soil in the United States and it is a tremendous tribute to the 5 States which have taken the lead in implementing the concept.

At latest count, 35 States and the District of Columbia have adopted the concept in one form or another. Twenty-seven States and the District have designated at least one zone. Impressive statistics for job creation and retention and business investment have been reported in the State Enterprise Zones. Figures compiled in May, 1987 report that over 114,000 new jobs plus an additional 67,000 retained jobs and almost $9 billion of new investment have been created in those State zones.

More important than these numbers, however, is the fact that State Enterprise Zones have emerged as an important new tool in economic development and have been used to support State and local strategies to revitalize distressed areas.

Most important of all—the Enterprise Zone experience has provided hope where there was none, and created jobs when they either were not there or were declining, and has served as a tremendous shot of adrenaline to reverse economic decline and stagnation.

One of the Enterprise Zone developments which we have observed is the use of Enterprise Zones in small towns and rural areas. Several States specifically provide for such zones. In general, the approach in these cases tends to be an emphasis on job and business retention and modest expansion as part of an overall State and local economic development strategy.

Much as we applaud its potential to assist in the economic revitalization of distressed areas, we would like to see coverage of the bill expanded to include urban and rural areas as well as Indian Reservations.

Our reaction to the incentive package is generally positive, particularly the provision of special assistance by Federal agencies to Enterprise Zones. However, because of the revenue implications, as the Treasury Department already has testified, we are not prepared to embrace specific incentives at this time.

HUD is prepared to publish regulations within the time frame specified in the bill and carry out the designation of zones on a timely basis. HUD's field offices will play a key and crucial role in this program, and we will build on the experience already of the States.

The Administration remains committed to the Enterprise Zone concept and welcomes the opportunity to work closely with the committee in determining an appropriate Federal role to augment the rich experience of the States to date.

Thank you.

[The prepared statement of Mr. Stokvis appears in the appendix.]

Senator BAUCUS. Thank you very much.

Mr. Frank Swain?

STATEMENT BY FRANK SWAIN, CHIEF COUNSEL FOR ADVOCACY, SMALL BUSINESS ADMINISTRATION, WASHINGTON, DC

Mr. SWAIN. Thank you, Mr. Chairman, and Senator Danforth.

I will depart from my prepared remarks to attempt to summarize what I feel are the key points. I appreciate your interest in holding this hearing and Senator Danforth's long-standing interest in the concept of Enterprise Zones, and particularly in the concept of rural Enterprise Zones.

Senator, when I went to a meeting in St. Louis about a year ago, I had the occasion to do some statistical research about what the economy was like at least a year or so ago in Missouri. I found out, I am sure not to your surprise, that the Greater Kansas City area and the Greater St. Louis area were doing very well, or quite well, and the rest of the State was almost directly the opposite. Clearly, as business picked up and as it has picked up in the recovery, your experience in Missouri, as Senator Baucus's opening remarks indicated, is I think characteristic of many areas of the country where we have spots in this country that are doing very well economically, where there is a successful group of businesses, and other places that aren't.

The question is: How do you get the areas that aren't doing very well to improve? We tend to think in terms of small business, because we are all used to hearing the job-generation statistics about how small business brings progress to the economy. Oddly enough, as we discovered in preparing some remarks several months ago for some hearings that Senator Baucus had in the Small Business Committee, small business growth has not been occurring in the rural areas. I think if we can stimulate greater small business growth in the rural areas, that is a major key to stimulating economic development in general.

The job-generation growth of small businesses has been largely an urban phenomenon, unfortunately. We haven't been very good at seeding or growing those smaller firms in rural areas.

In a nutshell, I liked your bill. I think it is very good. My colleagues in the Treasury Department and of course in the White House say that it is a good bill but now is not the time to endorse it, because we have an overwhelming macro-budget and tax policy issues that we have to hash out. And of course I defer to and agree with their opinion.

But inasmuch as I regard this hearing as an important way of building a record for the time at which decisions might be able to be made on this, let me try to address a couple of the specifics.

Senator Baucus has asked each of the witnesses a question of what economic development techniques they feel to be the most effective. I will defer to the gentleman from Cuba for his practical experience. I can tell you that as a general rule I think, from a small business perspective, tax credits or incentives focused at the employer-employee relationship, broadly stated, are more important than the capital incentives. In fact, if one of the reasons to seed small business growth in rural areas is to employ the indigenous population that is unemployed, and you have to choose between labor incentives and capital incentives, I would think that the choice of labor incentives is more important, because you want to stimulate businesses in those rural areas that are labor-intensive. Businesses that are capital-intensive aren't necessarily going to give you as much bang for your buck in the rural areas.

So, if you have to choose, for instance, between the employment tax credits and the capital gain rollover and ACRS changes, and so on, I think generally speaking small firms would say employment tax credits are more important.

I think that also makes sense if you look at what rural areas are rich in. They are rich in potential employees, and they are rich in a stable, a literate, and a trainable workforce. Land and other sort of capital factors of production are not as expensive in rural areas as they may be in urban areas. So I think, to the extent that you have to pick among the incentives, pick and choose on the side of employment-based incentives. That is going to be more important to small firms, at least. A broad generalization.

Second, I think the regulatory elements are very important, and I would continue to emphasize those. I would continue to bring pressure, frankly, on all of the agencies of government at the Federal and State level, once some sort of zone mechanism is enacted and put into law, that these be followed up on, because there is a lot of lip service given to regulatory relief, but we really need to make sure that it works.

Finally, I think the provision in the bill calling for special administrative efforts and assistance among Federal agencies in rural areas is extremely important. There must be a dozen agencies in the Federal Government that have as some part of their charter and mandate, somewhere along the line, to help rural areas. We are very poorly coordinated in that effort, and the SBA can take its share of the blame, along with everyone else. So, I think that that is a major mandate of the bill, something that we are already taking seriously at the Small Business Administration, regardless of whether the bill is enacted now or sometime in the future. We are certainly trying to work with other Federal agencies that already have programs, to make sure that we are not crossing our wires with them and making sure that we get the most bang for the buck from Federal assistance that is already available.

I would be happy to respond to any questions.

[The prepared statement of Mr. Swain appears in the appendix.]

Senator BAUCUS. Thank you, Mr. Swain.

Mr. Roedemeier?

STATEMENT OF DENNIS D. ROEDEMEIER, PRESIDENT, CUBA INDUSTRIAL DEVELOPMENT AUTHORITY, CUBA, MO, ACCOMPANIED BY MICHAEL WOLF, DIRECTOR, EZ PROJECT

Mr. ROEDEMEIER. Thank you.

I am from Cuba, Missouri. As a reference point, Cuba is a town of 2,100 people in Crawford County. Cuba's claim to fame, I guess, came in September of 1984 when three plants in Cuba shut their doors and put more than 100 unemployed people on the street. By November the unemployment rate in our city was 13 percent, and worse than that it was climbing. Two out of three that you would pass on our street every day were under the Missouri poverty level.

By Christmas day, if one more company would have closed their doors, our largest employer would have been the welfare agency at our county seat. We would have had more people supporting our unemployment than supporting our industry. And unfortunately, in a situation like that, one-half of the people who were injured from this unemployment weren't old enough to work.

In the story of Cuba, it had tremendous emotional impact, of course, on our people, but it is not unlike or too unsimilar to all the stories that you hear across America every day. You have heard from people in this room that they have witnessed these same phenomena, and I guess the existence of economic distress is not new. But I think what disturbs all of us is the recurrence of it and that it is occurring in places that we never expected it to happen before.

When Cuba lost its small shoe industry of 60 people, I am sure that that was just a blip on the screen of an economic indicator somewhere. But yet, when St. Louis announced that General Motors was going to have a cutback of 2,500 people, that shook the very foundation of our State. And if you think about it, what is the difference between a small rural town—what is the difference in that foundation?

Unfortunately, 11 million Americans have found out since 1981 that there no longer is the manufacturing base. And these are 11 million people like you and I who have kids to feed and families to raise.

As we view these situations and these hardships on the evening news, or as we read about them in the periodicals, we feel like many of the government people have said, that we are victims, that the farmer or the small businessman in rural America is eventually, from the roll of the dice or fate, going to receive his fair share of despair. We read about it, we talk about it, and we think about it, and I know everyone worries about that. Television perpetuates the idea of the economic victim.

Distressed communities are shown throughout the nation as this despair.

So, the question is: What do you do? The answer, "There is nothing we can do; there is no answer. We are only one. We are so small. What can be done?"

How does a community fight back? And what is the answer for this economic destitution that we have seen?

The existence of the programs to stimulate economic development are not new. The problem is that these programs often confront or deal with the symptoms of economic distress, and we have heard a lot about symptoms today. The major hurdle for a community to overcome is that excessive welfare programs, poor housing, these vacant storefronts you heard about with the boards on the front of them, poverty, and economic destitution these are only symptoms of a disease. They are not the disease.

The disease and the cancer that is ravaging so many of our communities is the lack of jobs. And if you take that, and if you believe that, then how can we accept the many budget situations where we see that 30 percent of State dollars are spent on welfare and social services, and 1 percent or less than 1 percent is spent on economic development? That one decision would get you fired in every board room across America. That one factor, the creation of jobs, is often the difference in the survival or extinction of many of our communities across America.

If we accept this basic premise, and if we choose to focus on job creation, then how do we create the jobs? The Enterprise Zone Program.

This is what brought Cuba back. It was the catapult that shot us forward, and it was the weapon that we used to fight the demise of Cuba.

I am going to go through a few items that we have found worked and a few items that didn't work, with the hope that maybe this might clarify our theory.

The enterprise zone, number one, must be a marriage of State effort, county effort, and city effort, and we have heard that discussed already. There should be a specific number of zones established, which I see you set forth in your bill.

Enterprise zones should be awarded to eligible areas on the basis of severe competition. In order for an eligible zone to win a designation, they must present a written business plan. This is very important for a community's survival, their ability to write a plan.

There should be a limited number of zones. The enterprise zone benefits should be extended to companies which basically manufacture, process, distribute, or assemble. It may be best to avoid extending benefits to the retail or commercial enterprises in a zone area. That can be a hot issue, but it is true.

Each zone should have a transfer-of-technology center that places it with a local university.

Finally, one of the hottest issues that is talked about is the giveaway programs, and what are States and counties and cities and the Federal Government willing to do to create jobs?

I want to explain just what the City of Cuba did. We gave away the land in the industrial park. We abated the taxes for 10 years. We gave a 30-percent rebate on utilities the first year, 20 percent the second year, 10 percent the third year, 5 percent the fourth and fifth. County abatement of taxes. Free utilities. We even gave away the gravel in the county for the roads and the parking lots.

When that plan originally was directed, it received a severe amount of criticism. But let me give you the results as of today from the Enterprise Zone Program in our county:

Food stamps in our county have been reduced from $85,000 a month to $55,000 a month, a savings of $360,000 per year to the taxpayers.

Unemployment has dropped from 14 percent to 5 percent. Hardcore unemployment in our county has been cut in half.

Sales tax revenues—we talked about the revenue stream—are up 33 percent. City revenues are up over 50 percent.

Fifteen industries have located in this Enterprise Zone in the last two and a half years. They have created 850 jobs, with an infusion of $12 million into our city. And the storefronts which at one time were empty. Today, they are all filled.

A Midwest Governor one time said that it is a very strange phenomenon, it seems that they put to work the philosophy that the more they give the more they receive. How strange that a Christian philosophy such as this works so well in current economic theory.

Thank you.

[The prepared statement of Mr. Roedemeier appears in the appendix.]

Senator BAUCUS. Thank you very much, Mr. Roedemeier.

Gentlemen, I very much appreciate what you are doing here. In my State of Montana, which is probably not too dissimilar from a lot of States, particularly Western States, we have a lot of rural economic depression. It is severe. And as Senator Danforth pointed out and as other witnesses have testified, including Senator Bond, most income in rural America is not farm income. That is, the folks who live either on the farms or in the smaller communities have to supplement their income to survive. And not only must we try to maintain a very strong agricultural base, we must also find ways to encourage and stimulate businesses in smaller communities so that that supplemental income will be there.

This is a subject that a lot of people have wrestled with for some time, and I frankly think that rural enterprise zones are a good idea—that is, they are a part of the solution. They are not the total solution, by any stretch of the imagination; but like almost everything else, there is no panacea, there is no quick fix, there is no meted cure-all. Rather, the solution depends on a continued, dedicated series of step-by-step, incremental improvements over what we now have. That, in my judgment, is the only way we are going to develop. This is one way among many which will probably help rural America.

I strongly believe that, unless we as a country spend more time figuring out how to develop our country nationally, which includes all Americans, and that means rural America, we are going to find ourselves as a country, in the next 15 or 20 years in pretty poor shape. This is a national problem.

I can't say precisely how quickly these bills will become law, but I can say that I think they are a good idea. And I very much appreciate the contribution that you have all made.

Senator Danforth.

Senator **Danforth**. Let me first address the question of the budget.

We have heard testimony that 62 percent of the income of farm families comes from nonfarm sources. That is farm families.

Now, Mr. Roedemeier in Cuba, Missouri, where I would imagine there are a lot of people who are not farm families but who live in Cuba who would not be counted even in that figure. Isn't that right?

Mr. **Roedemeier**. That is correct.

Senator **Danforth**. So, an overwhelming amount of the total income source that is available to smaller communities is from nonfarm sources. Isn't that right?

Mr. **Roedemeier**. Yes.

Senator **Danforth**. We are spending $26 billion a year on farm subsidies, and we have heard testimony from the Treasury Department that the cost over three years of a much more expanded enterprise zone concept was $1.5 billion spread over three years, and that was for 75 enterprise zones. Some of them were urban. We are talking here about a much cheaper program than a half-billion dollars a year, as compared to $26 billion a year in farm programs, when the overwhelming percentage of the income sources for people who live in rural parts of our country are from nonfarm sources.

So I would say to those who have expressed concern about the budget—and I, too, am concerned about the budget—that I don't understand why Rural Enterprize Zones are not a priority, when the largest source of farm income is not from the sale of agricultural commodities but from non-farm job opportunities within a rural community.

Let me also ask this to our experts. And Mr. Wolf, you haven't had your inning yet, but you might want to address this, too: My observation is that people who live in rural areas are very productive can-do people. They are people who are used to work, they know the work ethic, they know what it is to get up in the morning and get going, they know how to make equipment work. Am I correct in thinking that if we are concerned about productivity in this country, one way to increase our productivity is to increase the amount of manufacturing that goes on in rural areas? Is that a reasonable statement, or is that just my own observation?

Mr. WOLF. It certainly seems to be a fair statement. And the experience in Cuba is not necessarily atypical; there are other rural areas throughout the country that have used State and local enterprise zone types of incentives to generate increased employment and capital investment, places such as Kentucky, Mississippi, Minnesota, several other States.

Indeed, we would be foolish to label the program "urban enterprise zones," as it was originally. There are now urban, rural, and suburban zones, and the newest States that have passed enterprise zones, in the past year or two—Vermont, West Virginia, Colorado, Maine, Oregon, Hawaii, Arizona, even New York—have a heavy nonurban component to their zone program.

Senator DANFORTH. And it works, doesn't it?

Mr. WOLF. Yes.

Senator DANFORTH. It clearly works?

Mr. WOLF. Yes. Yes, it works, because it is the tool that brings together the public and private sectors, and also brings together State and local governments; and certainly, all appearances are that if there were Federal incentives it would do even more to stimulate that State and local public/private partnership.

Senator DANFORTH. What is the alternative? Is the alternative just to pull the plug on rural America? Is that the alternative, just to say, "Well, the dislocation that is now going on in rural America will continue to go on for an indefinite period of time," while we fiddle around with this budget?

Mr. WOLF. Well, the alternative is for those people who live in rural areas to commute to urban areas that are perhaps a hundred miles away, which is what happens in Missouri, for example.

[The prepared statement of Mr. Wolf appears in the appendix.]

Senator DANFORTH. That is absolutely correct, they travel tremendous distances. People go from Cuba into St. Louis, don't they, Mr. Roedemeier?

Mr. ROEDEMEIER. Yes, they do.

Senator DANFORTH. A lot of people do, I would guess.

Mr. ROEDEMEIER. That is right. And if you could imagine the hours they spend in their cars and away from their families, look at the impact that has on the family unit. These people would prefer to live and work at home with their families. I think we should give them that right.

Senator DANFORTH. Just to refresh my memory as to your testimony, when you were talking about the decline of Cuba, the dark days of Cuba, that was in 1984?

Mr. ROEDEMEIER. Yes.

Senator DANFORTH. In 1984 the unemployment rate was what?

Mr. ROEDEMEIER. The Economics Department of the University of Missouri just came out with a report that said it had reached 20 percent when we were at our low ebb.

Senator DANFORTH. And would you tell us how enterprise zones entered into this? What did you do? You were the person. One of the things we could do is clone you and spread you around the country. [Laughter.]

But what did you do with enterprise zones? How did you use enterprise zones, and what was the effect of it?

Mr. ROEDEMEIER. Well, my background is business, and we approached it simply as a business problem. We saw the enterprise zone as the best marketing tool available to create new industries.

A lot of people have the misconception that you run around and grab other industries and bring them in. Well, that is not the case, at all. What you do is, you create an environment where new industries will grow and where the small businessman can take advantage of it. You will find small business people grab the concept quicker on enterprise zones than major corporations, because major corporations are more docile, they are larger structured, and they are not as quick to grab an advantage as a small business, which is great because small businesses are the guys who create the jobs. It doesn't take them long to put together the list of advantages, and that is what they all do. They lay the list of advantages—be it Federal advantages for taxes, county advantages, banking advantages, which is another key to the program—and then they lay that across on their income statement.

One of the shoe companies which was about to close in Steelville, Missouri, decided not to close because we were able to get the enterprise zone package—not in to the president or the general manager, we got it into the tax department. And they made the recommendation that we should not close this plant. In fact, they made the recommendation that we should increase it by 80 jobs. That is what an enterprise zone can do for a small community, and that is basically how we did it.

Senator DANFORTH. Thank you.

Senator CHAFEE. Mr. Roedemeier, one question. It seems to me that your success in Cuba was based upon far more than just the enterprise zones. In other words, you did lots of other things. Now, who owned the land?

Mr. ROEDEMEIER. The city owned the land.

Senator CHAFEE. The city owned the land?

Mr. ROEDEMEIER. Yes.

Senator CHAFEE. You gave them gravel, you said?

Mr. ROEDEMEIER. Yes.

Senator CHAFEE. You put in the roads; you did all kinds of things. What kind of companies did you get out of it? I know there is a tremendous spinoff effect—if you get the companies, then J.C. Penney's store will stay, and all of that. But what were some of the companies? Were they major ones?

Mr. ROEDEMEIER. No, they weren't. The companies that we have in there are very diversified, and you know that was one track we wanted to never get into again, and I guess all municipalities in rural America do not want to get trapped to the single industry again, to get laid in with mining or with shoes.

We went into the four areas that we felt we were best at: we are good at automotive, we were good at wood products, we were good at chemicals, because of the University of Missouri Chemistry Department, and we were also, I think, very good at food processing, but I have been unable to accomplish that. So, those were the areas.

Now, the other thing, the marketing program that we put down was for companies of 25 to 35 people; that was our market niche, we felt. We have been able to secure a larger company than that recently. We were talking about international—we brought in a company from Toronto, Canada. They were moving to Mexico because of the labor rate. You know, we fight that. But they were not willing to give up the technology that was available.

And you asked another key as to what it was for this enterprise zone, it was the involvement of new technologies which we transferred to startup businesses and existing businesses. It is one thing to create the jobs, but you also have to have a competitive company.

Senator **CHAFEE**. Where did you get your money from to do these things, to pay for roads and so forth? Was it EDA grants?

Mr. **ROEDEMEIER**. Most of them were through block grants, where we actually had the customer or the business which was moving in, and we said, "We need this road." We used what is called a MODAG, which is Missouri's answer to UDAG.

Senator **CHAFEE**. State money?

Mr. **ROEDEMEIER**. State money, but I think it is interesting to know we also used a Federal program which is called a "revolving loan fund program." And I know the standard that we talk about so much is the creation of a job for $10,000, but the jobs that we have created we have created for under $1,000 per job. And it is only common sense. If it costs us $20,000 in this nation to keep a man out of work for two years, why shouldn't we put him to work for $2,000? It makes sense to me.

Senator **CHAFEE**. Well, if you can put him to work for $2,000, we ought to get you down here in Washington, but maybe that might kill you off.

Senator **DANFORTH**. No, let us leave him where he is. [Laughter.]

Senator **CHAFEE**. All right.

Any other questions?

[No response.]

Senator **CHAFEE**. Fine.

Mr. Stokvis, I appreciate the mention you made about the work that I have done on this in the past years. We gave it a full shot, and I am very interested in it, still. Thank you.

Thank you very much, gentlemen, for coming.

Our next witness will be Dr. Tom Lovejoy, Executive Vice President, and Ms. Katheryn Fuller, Vice President and General Counsel, the World Wildlife Fund. Would you please come forth? And Terrill Hyde, is she present with you?

Ms. **HYDE**. Yes.

Senator **CHAFEE**. Okay, Dr. Lovejoy, why don't you proceed. We have your statement, so you may proceed as you wish.

STATEMENT OF DR. THOMAS E. LOVEJOY, EXECUTIVE VICE PRESIDENT, WORLD WILDLIFE FUND, ACCOMPANIED BY KATHERYN S. FULLER, VICE PRESIDENT AND GENERAL COUNSEL, AND TERRILL HYDE OF WILMER, CUTLER & PICKERING, OUTSIDE COUNSEL

Dr. **LOVEJOY**. Mr. Chairman, of course I appreciate the opportunity to testify about S. 1781, providing a cost basis deduction for banks contributing international debt to qualified organizations for international conservation.

I would like to point out that this is legislation supported by a number of conservation organizations active internationally; it is not a World Wildlife Fund exclusive bill. Any 501(c)(3) engaged in international conservation would be eligible.

I would also like to note that we appreciate the interest the Treasury has taken and efforts to facilitate the movement of some international debt into this area of activity; but their Ruling 87-124 really was only published today. We have not had an opportunity to study it completely. But we do have some concerns, some of which emerged in the earlier discussion and questioning.

Senator **CHAFEE**. I would say, Dr. Lovejoy, when your folks have studied this, I think it would be very important for you to send down those views to us. We can put them in the record. And also, I personally, and the other members, would like to know what they are. So be sure and do that. I know that you haven't had time to get into it in great detail, but we would be interested in what you do have, your thoughts to date on it. We would take that in the regular context of your presentation.

Dr. **LOVEJOY**. We certainly will.

[Information appears in the appendix.]

Dr. **LOVEJOY**. In any event, there is no need to dwell at all on the conservation need. We all know that it is tremendous, unprecedented in human history, and largely concentrated in the Third World nations, principally those in the Tropics, many of which are burdened by international debt.

I would note that there is an important economic aspect to this, in the sense that it is now generally accepted that a sound economy must in the end be based on sound ecology.

Debt equity swaps for commercial purposes have been rather widespread. Billions of dollars of such activity has gone on in Chile, for example, and I would point out it is possible to use international debt for conservation purposes without this legislation; but we are very limited by the modest working capital available to private conservation organizations.

One of the most recent and certainly the most sophisticated such arrangement recently brought to pass is a proposal by Ecuador, in which the central bank at the end of the process will confer bonds of nine-year duration on the local leading private conservation organization, essentially endowing it, and providing an income which will literally, among other things, double the national budget for national parks.

The other important aspect of the Ecuadorian arrangement is that it was largely structured at the initiative of the conservationists in Ecuador. These are very sensitive and delicate matters, touching occasionally on concerns about national sovereignty, which relates directly to the point that was raised earlier this morning of the difficulties of a central bank turning around and providing funds directly to a foreign organization. There certainly are a number of countries in which this would be very difficult to do. Brazil is perhaps the most obvious of such countries; Mexico would be one, also.

So, we have a definite preference for the mechanism available through this S. 1781, because it allows the flexibility and the sensitivity to local conservation organizations and local sensitivities.

Basically, what we are interested in in this legislation is the opportunity to use more of the international debt than would be available to us through straight purchase because of our limited funds. That is the rationale behind the bill, and certainly that rationale is supported in principle by Secretary Baker's letter of June 25, which I believe is already part of the submitted testimony.

In conclusion, I would like to make the statement that, although this is structured as a deduction for the banks, we certainly view this as a conservation bill, not a bank bill.

Under present law, banks would prefer to donate dollars rather than debt, and we want the debt. The reason we want it is because we can achieve a great deal more, we can achieve much greater value, by using the debt and redeeming it at face value in the country in question. The bill helps us accomplish this objective.

Thank you.

[The prepared statement of Dr. Lovejoy appears in the appendix.]

Senator BAUCUS. Thank you, Dr. Lovejoy.

You heard the conversation we had with the Assistant Secretary of the Treasury; what is your reaction to his comments, that is, his comments in support of the Treasury Ruling approach rather than a statutory approach?

Dr. LOVEJOY. Well, I have reservations which I raised just a few minutes ago about the political difficulties of operating through the ruling mechanism, because you have to have the banks of these countries come back to you. I certainly have no problem with this bill as restructured so that the deduction consists of a loss plus the donation. All we are concerned about is for the banks to have the incentive to give us the debt rather than the fair market value in dollars.

Senator BAUCUS. What about the recordkeeping concern that Treasury has? Do you think that is a legitimate factor?

Dr. LOVEJOY. I fail to see why it should be any different from any of the commercial debt-equity swaps. There is a market out there, and if it can be done for commercial purposes, why discriminate against nonprofit purposes?

Senator BAUCUS. Thank you.

Senator Chafee?

Senator CHAFEE. Thank you, Mr. Chairman.

Could we just go through how the steps would work here?

Morgan Guaranty has a million dollars of Bolivian debt. And that debt now, let us say, is worth $600,000—that is, the paper is worth that. So thus, they could sell that for $600,000, take a $400,000 loss, and give the $600,000 to the World Wildlife Fund, and thus they would have realized the 100 percent deduction either through loss or through donation. Okay.

So, instead they give the million dollars worth of paper to the World Wildlife Fund, which is a 501(c)(3) U.S. charitable foundation, corporation. So then, you go down and you say to the Bolivian Government, "We will give you a million dollars worth of your debt. If you cancel it, we will return it to you—turn in this paper." And then, what? You negotiate with them on what they will do in return?

Dr. LOVEJOY. Yes. And I think what you can get is a variety of possibilities. In certain situations you could just get straight cash, local currency. In other situations I think there would be a strong preference for bonds, because they worry about the inflationary effect of releasing large amounts of cash into a small economy.

Senator CHAFEE. But they don't have the cash anyway, do they?

Dr. LOVEJOY. Sometimes they don't.

Senator CHAFEE. Well, let us say they think the thing is worth for you to give it to them under the deal that they would give you land, rain forest that they happen to have worth $700,000 or maybe a million dollars. Is that a possibility?

Dr. LOVEJOY. It is a possibility, but——

Senator CHAFEE. Not give to you, but give to their nature conservancy, or whatever it might be in Bolivia. In each of these countries is there a group that could receive this and manage it?

Dr. LOVEJOY. In almost every one of these countries there really are very strong organizations that are capable of doing that, and in a few where they are weak it is perfectly possible to tutor them and coach them.

Senator CHAFEE. And that of course is what you have been involved with.

Now, in taking Brazil, if you should turn in $10 million worth of bonds you would receive—"you" being World Wildlife—do the countries own the land there that they could then sell to or turn over in return for the redemption of the debt? Could they turn over $7 million of land? Do they own the Brazilian jungle, the Government?

Dr. LOVEJOY. They certainly have title to large stretches of it. However, of course one isn't restricted to what the government might turn over. If the local organization has the bonds or the cash, they can go buy private land as well.

Senator CHAFEE. Do you mean turn them in and get the cash and go buy the private land? But in that case, of course, the government has to come up with the dollars, with the cash.

Dr. LOVEJOY. That is right.

Senator CHAFEE. What do you think would be the effect of broadening this? The Treasury says, "Why restrict it to conservation organizations; why not to health organizations?"

Dr. LOVEJOY. Well, certainly in principle we have no objection to doing that. Our approach was kept to the narrow definition from concerns about not creating a large revenue problem and an objection from Treasury.

I also have to say that I do worry about what might happen from political reaction in these countries if everybody jumped in the pool at once. But presumably there are ways of coordinating such activities.

Senator CHAFEE. Well, I don't know whether that is so bad. Presumably the countries wouldn't have to redeem the debt at 100 cents on the dollar.

Dr. LOVEJOY. Well, that is certainly true, but they do have these sensitivities about people coming in from outside, with whatever instrument, and trying to do a lot of things. Sovereignty can be a very touchy issue.

Senator CHAFEE. It was their debt. They issued the debt.

Dr. LOVEJOY. That is certainly true, but that doesn't necessarily mean that you don't get sensitivity.

Senator CHAFEE. They are sensitive about people redeeming their debt?

Dr. LOVEJOY. Well, certainly. I mean, Mexico at the moment has just refused to do any more debt equity. Brazil has been very resistant about it. It is not, in my view, a rational response, but it exists, and one has to be aware of it.

Senator CHAFEE. I see.

Well, I think you have made an excellent case here, in what you can help us with. Would your attorneys who are present want to comment at all on the downside of the recommendations of the Treasury Department, on what you have got to date and your thoughts to date?

Ms. Hyde?

Ms. HYDE. Do you mean on the revenue ruling?

Senator CHAFEE. Yes.

Ms. HYDE. The concerns with the revenue ruling are that it is structured differently than the mechanisms set up in the bill that you are sponsoring. And the difference is that in our bill the bank donates the debt to the U.S. 501(c)(3), then it can go arrange a swap which fits in with the sovereignty desires of the country it is doing the swap with. So that if that country wants to issue bonds and place them in a local entity or in a governmental unit and apply those bonds to some conservation purpose, in cooperation with a program that has been worked out with World Wildlife Fund, that objective could be achieved under our bill.

The concern we have with Treasury's approach is twofold: The first is that it requires an exchange between the U.S. bank that holds the debt and the central bank of the debtor nation. The concern there is that that may raise accounting concerns for the bank which might deter them from making these kinds of donations. We don't know that that would be the case, we have only——

Senator BAUCUS. What accounting concerns?

Ms. HYDE. If they donate the debt, no question would be raised about whether they are holding the debt for investment or not. We don't know how the accountants would view that issue if they exchanged the debt with a bank of the debtor nation. And this is a question that we have not been able to really get any response to, because we just got the ruling. The ruling was just allowed to be released so that the banks could look at it yesterday, and within the time constraints of getting ready for this hearing today we were unable to get a response on that.

The second problem that has been raised is that many Latin American countries are concerned—or other countries are concerned—for sovereignty reasons about giving local currency or crediting local currency to a foreign entity; i.e., a U.S. entity. And therefore, the swap would need to be arranged so that the currency could be credited or bonds could be issued to an entity that is organized in the foreign nation or that is an instrumentality of the foreign nation.

We are concerned, however, if we do the swap that way, under the Treasury ruling, it might raise questions about whether the bank qualifies for a charitable donation, because in order to get a charitable donation you have to make a donation to a U.S. charitable organization, you can't make it to a foreign qualified charitable organization.

If you wanted to work with Treasury on that issue, they might be able to help you.

Senator CHAFEE. Okay. And you are going to get in touch with us further on this with your thoughts?

Ms. HYDE. Yes.

Senator CHAFEE. Well, first of all I want to thank each of you, and especially Dr. Lovejoy, for what you have done in conceiving this. I know that the Chairman of the subcommittee shares my thoughts, that we are really in a crisis situation as regards this rain forest and what is happening down there because it affects us all; and particularly when we talk ozone layer or when we talk the greenhouse effect, all, it ties in with what is happening in both Central America and in Brazil.

So I suppose every individual who is interested in a charitable organization thinks that that group's work is especially unique; but I do believe that what we are dealing with here goes way beyond conservation and the need for parks in any community. I think this goes right to the climate of this globe. And thus, the idea of restricting it to this type of activity does not go against my grain, because of the international importance of it.

But if the Treasury wants to do it in a broader aspect, well, so be it. We try to tailor it to satisfy the Treasury.

Thank you very much, all of you.

Senator BAUCUS. I want to thank you all, too. I just have one question. Senator Chafee I think very forcefully and with great articulation demonstrated the growing awareness in this country of the need to address global climatic problems. I wonder to what degree various Third World debt countries—in a certain sense, we are a Third World debt country now, too—are also sensitive to that problem. That is, are the countries that you are potentially dealing with as concerned about rain forest obliteration and other kinds of global climatic problems as are some folks in this country?

Dr. LOVEJOY. It certainly varies from country to country, but the growth of concern in these countries over the last 10 years is very impressive indeed and I guess is what keeps us all struggling with the problem.

Senator BAUCUS. I wonder, are they clamoring for this kind of legislation? Are they aware of it, interested, intrigued? How could you very generally categorize their position?

Dr. LOVEJOY. Well, I think the responses we have already seen. We have seen the deal, if we can call it that, done in Bolivia. We have seen an Ecuadorian initiative that came out of no more than my talking to somebody and saying, "There is an opportunity here." Costa Rica is close to producing a final arrangement, and Kathryn, you may know of some others in the works.

Ms. FULLER. The Administrator of Natural Resources from the Philippines is coming to our offices in the beginning of December to talk about how they might structure a debt-for-nature deal, along with the leading nongovernmental organization in the Philippines. So there is tremendous interest.

In fact, the head of the Fundacion Natura in Ecuador is particularly pleased with himself, as he should be, for having put this very creative deal together with the Central Bank in Ecuador, because he sees that every other debtor country is going to be close on his heels, and he wants to be sure that some of the donations flow Ecuador's way.

Senator BAUCUS. Thank you very much. The hearing is adjourned.

[Whereupon, at 12:30 p.m., the hearing was adjourned.]

APPENDIX

ALPHABETICAL LIST AND MATERIAL SUBMITTED

DESCRIPTION OF TAX BILLS

(S. 788, S. 983, AND S. 1781)

Scheduled for a Hearing
Before the
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
of the
SENATE COMMITTEE ON FINANCE
On November 13, 1987

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION

November 12, 1987

JCX-20-87

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INTRODUCTION

This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of three tax bills scheduled for a public hearing on November 13, 1987, before the Senate Finance Subcommittee on Taxation and Debt Management. The hearing will focus on (1) S. 788 (relating to Indian enterprise zones); (2) S. 983 (relating to rural enterprise zones), and (3) S. 1781 (relating to charitable deduction for contributions of debt of developing nations for international conservation purposes).

The first part of the document is a summary. The second part is a description of S. 788 and S. 983. The third part is a description of S. 1781.

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[1] This document may be cited as follows: Joint Committee on Taxation, Description of Tax Bills (S. 788, S. 983, and S. 1781) (JCX-20-87), November 12, 1987.

II. SUMMARY

S. 788 and S. 983--Indian and Rural Enterprise Zones

Present Law

Tax incentive provisions

Targeted area

The Internal Revenue Code does not contain general rules for targeting areas for special tax treatment. Within certain Code sections, however, there are definitions of targeted areas for limited purposes. For example, the provisions relating to qualified mortgage bonds define targeted areas for the purpose of promoting housing development within economically distressed areas.

Tax credits for employers

There are no general provisions in present law under which an employer's tax liability varies according to the location of its employees. The targeted jobs tax credit in present law does, however, provide a targeted jobs tax credit for a portion of wage payments made to certain groups of employees.

Investment tax credit

An investment tax credit is allowed under present law for qualified rehabilitation of structures: 20 percent for rehabilitation of a certified historic structure and 10 percent for rehabilitation of a building originally placed in service before 1936.

Under prior law, a 10-percent investment tax credit applied to eligible tangible personal property used in a trade or business or for the production of income. The basis of the property was reduced by one-half of the amount of the credit.

Capital gains

Net capital gains are taxed as ordinary income under present law, except that the maximum tax rate on net capital gains in 1987 is 28 percent. Before 1987, net gains from the sale or exchange of a capital asset were taxable at a reduced rate. Noncorporate taxpayers could reduce net capital gains by 60 percent, and the remainder was taxed as ordinary income--effectively establishing a maximum 20-percent rate. The maximum tax rate for corporate capital gains was 28 percent.

Private activity bonds

Although interest on State or local government bonds used to finance trade or business activity generally is taxable, various exceptions are provided, including bonds issued as qualified small-issue bonds, qualified redevelopment bonds, or to finance certain other private activities. Issuance of private activity bonds generally is subject to State volume limitations.

Non-tax provisions

Foreign trade zones

A foreign trade zone may be established within any port of entry. Duties are not levied on imported goods shipped into a foreign trade zone until and unless such goods are sent into other United States territory.

Regulatory flexibility

Present law provides that certain regulatory procedures are to be followed in order to ease the regulatory burden on small businesses, small nonprofit organizations, and small governmental jurisdictions.

Overview of Bills

Designation of enterprise zones

The bills (S. 788 and S. 983) would authorize designation of enterprise zones, for Indians and rural areas, respectively. Special tax incentives and other benefits would be available in the designated zones.

Indian enterprise zones would be designated by the Secretary of the Interior after nomination by an Indian tribal government. Rural enterprise zones, which could include such zones in an Indian reservation, would be designated by the Secretary of Housing and Urban Development. Each zone would have to satisfy various requirements concerning demographic and physical characteristics and levels of poverty, unemployment, and economic distress.

In both bills, State and local, and Indian tribal, governments seeking designation of a nominated area as an enterprise zone would be required to commit to specific actions with respect to the zones to enhance their development. These actions would include (1) reduction of tax rates and fees, (2) increasing efficiency levels of local services, (3) reduction or simplification of governmental requirements applicable to the zones, and (4) involving local private entities in the programs, including commitments to provide jobs and job training and other related technical or financial assistance for employers, employees, and residents of the designated areas.

Tax incentive provisions

Employment tax credits

Both bills would provide a 10-percent tax credit for employers who increased employment expenditures in the designated zones.

In addition, S. 788 would provide a credit on qualified wages of each qualified ecnomically disadvantaged individual. The credit would be 50 percent of wages during the first 36 months of employment and would phase out completely after 7 years of employment.

Capital gains and losses

S. 788 would exclude from gross income capital gain on qualified Indian enterprise zone property.

S. 983 would provide that gain on sale of rural enterprise zone property would not be recognized if the taxpayer used the proceeds within 12 months to acquire other rural enterprise zone property.

Private activity bonds

Both bills would repeal the present-law sunset date applicable to qualified small-issue bonds and would allow accelerated cost recovery methods to be used instead of straight-line depreciation for property financed with private activity bonds for use in designated zones.

S. 788 also would permit Indian tribal governments to issue private activity bonds in addition to those bonds they may issue currently for essential governmental functions.

Investment tax credit

S. 788 would restore the investment tax credit for Indian enterprise zone property. A 5-percent credit would be allowed for zone personal property. A credit of 10 percent would be allowed for new zone construction property. Zone infrastructure would be allowed a 20-percent credit.

Tax simplification

S. 983 contains a Sense of the Congress resolution that would require the Secretary of the Treasury to simplify administration and enforcement of Code provisions amended by the bill.

Other provisions

Foreign trade zones

S. 788 and S. 983 would require the Foreign Trade Zone Board to expedite any application involving establishment of a foreign trade zone within an Indian, or rural, enterprise zone. The Secretary of the Treasury would be required to expedite applications to establish ports of entry in an enterprise zone (needed to establish a foreign trade zone).

Other provisions in S.788

A provision would be provided to encourage conflict resolution in an Indian enterprise zone. Additionally, the Indian Self-Determination and Educational Assistance Act would be amended by allowing an additional 5 percent of the amount paid on any Federal contract with respect to a subcontractor which is an Indian organization or an Indian-owned organization to be added to the contract price.

Other provisions in S. 983

Federal agencies would be directed to pursue regulatory flexibility by modifying or waiving agency rules that relate to an activity carried on in a rural enterprise zone.

Similarly, Federal agencies would be directed to provide special assistance to rural enterprise zones in the form of rules to expedite processing, establish priority funding and program set-asides, and provide technical assistance in furtherance of the bill's purposes.

S. 1781--Charitable Deduction for Debt of Developing Countries

Present Law

A charitable contribution deduction arising from the donation of depreciated property is generally measured by the fair market value of the property. If the loss inherent in the property would be deductible to the donor upon realization, however, a greater combined deduction can be achieved by realization of the loss followed by a donation of cash equal to the fair market value of the property.

Overview of Bill

The bill provides that certain charitable contributions of instruments evidencing debt of certain foreign countries will give rise to deductions no less than the donor's basis in the instrument. To qualify for this treatment, the bill requires that the donee promise to use the gift for a conservation purpose relating to the debtor country.

II. DESCRIPTION OF S. 788 AND S. 983

A. Present Law

Tax incentive provisions

Targeted area

The Internal Revenue Code does not contain general rules for targeting areas for special tax treatment. Within certain Code sections, however, there are definitions of targeted areas for limited purposes. The provisions relating to qualified mortgage bonds define targeted areas for the purpose of promoting housing development within economically distressed areas. Within such areas, which are defined on the basis of the income of area residents or the general economic conditions, rules for the financing of owner-occupied homes with qualified mortgage bonds are less restrictive than the generally applicable rules.

Tax credits for employers

There are no provisions in present law under which an employer's tax liability varies according to the location of its employees. The targeted jobs tax credit in present law provides a tax credit for a portion of wage payments made to certain groups of employees. These groups generally are defined according to the employees' physical condition, participation in a specified education or rehabilitation program, or economic status.

Investment tax credit

An investment tax credit (ITC) is allowed under present law for qualified rehabilitation of structures: 20 percent for rehabilitation of a certified historic structure and 10 percent for rehabilitation of a building originally placed in service before 1936. A full basis adjustment is required for both credits.

Before 1986, a 10-percent ITC applied to eligible tangible personal property used in a trade or business or for the production of income. The basis of the property was reduced by one-half of the amount of the credit. The ITC was not allowed for real property.

Capital gains

Net capital gains are taxed as ordinary income under present law, except that the maximum tax rate on noncorporate net capital gains in 1987 is 28 percent. Before 1987, net capital gain from the sale or exchange of a capital asset was taxable at a reduced rate. Noncorporate taxpayers could reduce net capital gains by 60 percent, and the remainder was taxed as ordinary income--effectively establishing a maximum 20 percent rate. The net capital gains tax rate for corporations was 28 percent. Capital assets generally include any property held by the taxpayer with the exception of property used, or held for sale, in the taxpayer's trade of business. This reduction in tax was treated as a preference item for purposes of the noncorporate and corporate minimum taxes.

Private activity bonds

Although interest on State or local government bonds used to finance trade or business activity generally is taxable, various exceptions are provided, including bonds issued as qualified small-issue bonds, qualified redevelopment bonds, or to finance certain other private activities. Issuance of private activity bonds by States and local governments generally is subject to State volume limitations. The exemption for qualified small-issue bonds, expires after December 31, 1989.

Property financed with tax-exempt private activity bonds generally is allowed cost recovery deductions using the straight-line method over recovery periods longer than those otherwise allowed.

Indian tribal governments may issue tax-exempt bonds only for essential governmental functions; tribal governments may not issue private activity bonds.

Non-tax provisions

Foreign trade zones

A foreign trade zone may be established within any port of entry. Duties are not levied on imported goods shipped into a foreign trade zone until and unless such goods are sent into other United States territory.

Regulatory flexibility

Present law provides that certain regulatory procedures are to be followed in order to ease the regulatory burden on small businesses, small nonprofit organizations, or small governmental jurisdictions.

B. Explanation of S. 788
(The Indian Economic Development Act of 1987)

Designation of Indian enterprise zones

Definition of zone

Under the bill, an "Indian enterprise zone" would be any area which is nominated for designation by a tribal government and which is so designated by the Secreatry of the Interior (after consultation with the Secretaries of Commerce, Labor, Housing and Urban Development, and Treasury, and the Administrator of the Small Business Administration).

The Secretary of the Interior (Interior) would be required to prescribe regulations, not later than four months after the enactment of the bill, providing the procedures for nominating an area as an Indian enterprise zone, the parameters relating to the size and population characteristics of an Indian enterprise zone, and the manner in which nominated areas would be compared based on factors such as the tribal governments' commitments to reduce various burdens borne by employers or employees in such areas, and the levels of poverty, unemployment, and general distress in such areas.

Interior would have authority to designate nominated areas as Indian enterprise zones only during a three-year period following the month in which regulations published pursuant to the bill first become effective.

Period of effect of designation

Any designation of an area as an Indian enterprise zone would remain in effect until the earliest of (1) the end of 24 calendar years following the year in which the designation was made; (2) the termination date selected by the tribal government; or (3) the date Interior revoked the designation for failure to comply with the commitments made in seeking the designation.

Interior could revoke the designation of an area if the tribal government was not complying substantially with commitments it made in seeking the designation. Before revoking a designation, Interior would be required to consult with the Secretaries of Commerce, Labor, Housing and Urban Development, and the Treasury, and the Administrator of the Small Business Administration.

Requirements for designation

A nominated area could not be designated as an Indian enterprise zone unless:

(1) The area is within the jurisdiction of the tribal government. (An adjacent portion outside the jurisdiction of the tribal government would be treated as if it were within that jurisdiction so long as the adjacent portion was not more than twice as large as the nominated area actually within the jurisdiction of the tribal government.)

(2) The boundary of the area is continuous.

(3) The area is determined by Interior to be "Indian lands," meaning all lands within the boundaries of any Federal Indian reservation and all lands which were determined by Interior to be substantially governed by a tribal government.

(4) The tribal government certified and Interior accepted such certification, that the area is one of pervasive poverty, unemployment, and general distress, and that one of the following criteria was met: (a) the unemployment rate was at least two times the national unemployment rate for the period, or (b) the poverty rate (as determined by the most recent census data available) for each populous tract within the area was at least 20 percent for the period to which such data relate, or (c) at least 70 percent of the households living in the nominated area had incomes below 80 percent of the median income of households of the area generally.

(5) The tribal government agreed that, during any period during which the area was an Indian enterprise zone, such government would follow a specified course of action designated to reduce the various burdens borne by employers or employees in such area. The specified course of action could be implemented by both government and private entities, and could include: (a) a reduction of tax rates, fees, or royalties applying within the Indian enterprise zone; (b) an attempt to increase the level of efficiency of local services (e.g., crime prevention) within the Indian enterprise zone; (c) actions to reduce or streamline governmental requirements applying within the Indian enterprise zone; (d) involvement in the program by private organizations, neighborhood associations and community groups, including a commitment from such private entities to provide jobs and job training for employers, employees, and residents of the nominated area; (e) actions to assure non-tribal interests that their rights will be protected (such as separation of tribal courts from political influence, adoption of model legal codes, and adequate access and rights to the tribal courts; (f) actions to separate tribal business functions from the governmental aspects of the tribe; and (g) formulation of tribal plans, with proper zoning designation and enforcement.

Priority of designation

In choosing the areas to designate, Interior would be allowed to give preference to nominated areas with high levels of poverty, unemployment, and general distress and with respect to which the most commitments had been made (by the tribal government and private entities) to reduce burdens borne by employers or employees in such areas. Interior also would be allowed to give preference to nominated areas, the size and location of which would primarily stimulate new economic activity and minimize unnecessary tax losses to the Federal Government.

Reporting requirements

Interior would be required to prepare and submit to Congress a report on the effects of designating areas as Indian enterprise zones within four years after the year in which the first areas were designated as Indian enterprise zones.

Tax incentive provisions

Employment tax credit

The bill would provide a tax credit to employees for Indian enterprise zone employment. The amount of the credit would be equal to the sum of two amounts: (1) 10 percent of the qualified increase in an employer's employment expenditures and (2) the applicable economically disadvantaged credit amount for the employee. This computation would be made on a taxable year basis and would allow for carrybacks and carryforwards of unused credits.

Not all wages paid by an Indian enterprise zone employer would qualify for the increased employment expenditure portion of the credit. Only the amount of wages paid by an employer in designated Indian enterprise zones during a specified 12-month period, which exceeded the wages paid by that same employer during the immediately previous 12-month period, would be eligible. Also to be qualified wages for purposes of this credit the wages would have to meet the definition of wages currently in the code for (FUTA) employment tax purposes, with some modifications. One such modification would be the exclusion from the wage base of any Federally funded payments the employer received or accrued for on-the-job training. A second difference would relate to special rules for agricultural and railway labor. In no event, however, could qualified wages exceed 2.5 times the wage base for FUTA taxes. (Currently, the FUTA wage base is $7,000.) The bill also would provide that wages would not be taken into account for increased employment expenditures if they otherwise qualified for the economically disadvantaged credit, described below.

The second element of the credit computation would be the economically disadvantaged credit amount which would represent the sum of the applicable percentage of qualified wages paid to each qualified economically disadvantaged individual. The applicable percentage for the first 36 months of employment would be 50 percent. Between the 36th and 84th months of employment, the percentage would be gradually decreased to zero.

The term "qualified economically disadvantaged individual" would be defined as an individual who possessed each of four qualifications. First, the individual would have to be a qualified employee. Second, the individual would have to be hired by an employer in a currently designated area and would have to perform services for that employer in that designated area. Third, the individual would have to be certified as either (1) an economically disadvantaged individual, (2) an eligible work incentive employee, or (3) a general assistance recipient. (This certification would be made by the tribe in a manner similar to that under the targeted jobs credit. (Code sec. 51).) Fourth, the individual would be required to be an enrolled tribal member.

To be a qualified employee an individual would be required to satisfy a two-part test. The first part of the test would require that at least 90 percent of the services of the employee during the taxable year be directly related to the conduct of the employer's trade or business which was located in the enterprise zone. The second part of the test would require that the employee perform at least 50 percent of the services with respect to which the credit related during the taxable years in the Indian enterprise zone.

Investment tax credit for zone property

Under the bill, an investment tax credit would be allowed for certain investments in property that was used in the conduct of a trade or business within an Indian enterprise zone or that benefited the Indian tribal infrastructure.

Zone personal property.--A 5-percent tax credit would be available for all depreciable personal property. To be eligible for this credit, the property would have to be acquired and first placed in service by the taxpayer in an Indian enterprise zone during the period that the designation as an enterprise zone was in effect. In addition, the taxpayer would be required to use the property predominantly in the active conduct of a trade or business (including the rental of real estate) within the Indian enterprise zone and could not acquire the property from a related person.

Property used or located outside the Indian enterprise zone on a regular basis would not be eligible for the 5-percent credit. The credit rate would be reduced by 25 percent for the taxable year that included the twenty-first anniversary of the Indian enterprise zone designation, and by an additional 25 percent for each year thereafter. The basis of property eligible for the 5-percent credit would be reduced by half the amount of the allowable credit.

New zone construction property.--A 10-percent tax credit would be available for nonresidential real property, residential rental real property, and real property with a class life in excess of 12.5 years if (1) the property was located in the Indian enterprise zone; (2) the property was acquired or constructed by the taxpayer; and (3) the property was used predominantly in the active conduct of a trade or business (including the rental of real estate) within the Indian enterprise zone.

In the case of property acquired by a taxpayer, the credit would be available only if the property was acquired from an unrelated person after the designation of the zone and only if the original use of the property commenced with the taxpayer. In the case of property constructed, reconstructed, rehabilitated, renovated, expanded, or erected by the taxpayer, the credit would be available only to the extent of any construction, etc. after designation of the enterprise zone.

As with the personal property credit, this credit rate would be reduced by 25 percent for the taxable year that included the twenty-first anniversary of the Indian enterprise zone designation, and by an additional 25 percent for each year thereafter. The basis of property eligible for the 10-percent credit would be reduced by the full amount of the allowable credit.

Zone infrastructure investment.--A 20-percent tax credit would be available for Indian enterprise zone property that benefited the Indian tribal infrastructure and that was available to the general public. For purposes of this credit, Indian enterprise zone property would include property located outside the Indian enterprise zone but only if its purpose was to connect to existing tribal infrastructure in the zone. Examples of property eligible for the 20-percent credit would include roads, power lines, water systems, railroad spurs, and communication facilities.

Recapture.--If property for which an Indian enterprise zone credit was claimed by a taxpayer was disposed of, a portion of the enterprise zone credit would be recaptured. In addition, if property for which the 5-percent Indian enterprise zone credit was claimed by a taxpayer was removed from the Indian enterprise zone, or converted or otherwise ceased to be Indian enterprise zone property (other than by expiration or revocation of the designation of the zone), a portion of the enterprise zone credit would be recaptured.

The amount of the enterprise zone credit subject to recapture would be the difference between the amount of the credit allowed for the property and a recomputed credit based on the amount of time that the property was Indian enterprise zone property of the taxpayer. The recomputed credit would bear the same ratio to the amount of the credit originally allowed as the number of taxable years in which the property was enterprise zone property bore to the number of years over which the property was depreciated for purposes of computing earnings and profits.

Carryover period.--Unused Indian enterprise zone credits could be carried forward for the remaining life of the enterprise zone or 15 years, whichever was longer.

Capital gains exclusion

The bill would exclude qualified capital gains from a taxpayer's gross income. In general, qualified property on which a gain would be excluded would be defined as tangible personal property used by the taxpayer in its business within an Indian enterprise zone or any real property located in an Indian enterprise zone and used by the taxpayer in its business within such a zone. An interest in a corporation or partnership could be qualified property if the corporation or partnership conducted business in an Indian enterprise zone, generated at least 80 percent of its gross receipts from activities carried on within the zone, and had substantially all of its assets located within the zone. Rental real estate would be considered as qualified property. No property could be qualified if it was placed in service within the twelve months prior to the designation of the Indian enterprise zone.

Any property which qualified for the capital gains exclusion, would remain qualified if the designation of the zone expired or was revoked. However, after the first sale or exchange of qualified property following the designation of the zone had expired or been revoked, the property would cease to be qualified.

This exclusion would apply to long-term capital gains, that is, gains on those assets which the taxpayer had held for at least six months. All capital losses and short-term gains would receive present-law treatment.[2]

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[2] Prior to the 1986 Tax Reform Act, a 60-percent exclusion for long-term capital gains was allowed for individuals. At (Footnote continued)

Private activity bonds

The bill would permit qualified property which was financed with the proceeds of tax exempt bonds to use the accelerated cost recovery system which would apply in the absence of tax-exempt financing in lieu of the alternative depreciation system which generally requires straight-line depreciation over longer recovery periods for tax-exempt bond financed property.

Present law establishes a sunset date of December 31, 1989, for the issue of qualified small-issue manufacturing facility bonds. The bill would revoke the sunset date as it applies qualified small-issue bonds for facilities in Indian enterprise zones.

In addition, Indian tribal governments would be permitted to issue private activity bonds in addition to those bonds they presently may issue for essential governmental functions.[3]

Other provisions

Foreign trade zones

The bill would require the Foreign Trade Zone Board to expedite on a priority basis the processing and approval, to the maximum extent practicable, of any application involving the establishment of a foreign trade zone within an Indian enterprise zone. The Treasury Department would be required to give the same urgent consideration to an application for establishment of a port of entry (necessary to permit the establishment of a foreign trade zone within an Indian enterprise zone).

Conflict resolution in Indian enterprise zones

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[2] (continued)
the same time, the individual alternative minimum tax counted this exclusion as a preference item for minimum tax purposes. The 1986 Act repealed the exclusion and deleted capital gains as a preference item for alternative minimum tax purposes. The bill is unclear as to whether this exclusion of a long-term gain would be an includable preference item under the alternative minimum tax.

[3] The bill does not specify the treatment of these Indian tribal government bonds under the State private activity bond volume limitations of present law.

The bill would authorize the Interior Department to approve plans, pursuant to a tribal economic development plan, which included provisions for resolving conflicts between Indian enterprise zone parties. Such plans could provide for binding arbitration of contract and other civil disputes between tribal entities and non-tribal businesses or entities. Interior could not approve any plan, however, if it encumbered or diminished the trust assets of a tribe.

Indian self-determination and education assistance

Under the bill, any person who entered into a contract with a Federal agency under any Federal law would be allowed an additional amount of compensation equal to 5 percent of the amount paid to a subcontractor or supplier if such subcontractor or supplier was (1) an Indian organization, or (2) a commercial, industrial, or business activity organized for profit, which was at least 51 percent Indian-owned.

Effective date

The bill generally would be effective after December 31, 1986.

C. Description of S. 983
(The Rural Enterprise Zone Act of 1987)

Designation of rural enterprise zones

Definition of zone

The bill would amend the Internal Revenue Code to provide criteria for the designation of rural enterprise zones. A rural enterprise zone would be any area which was nominated as such by one or more local governments and the State or States in which it was located, and which was approved by the Secretary of Housing and Urban Development (HUD) after consultation with the Secretaries of Agriculture, Commerce, Labor, and the Treasury, the Director of the Office of Management and Budget, and the Administrator of the Small Business Administration. In the case of a rural enterprise zone on an Indian reservation, the Secretary of the Interior also would have to be consulted.

The term State would include Puerto Rico, the Virgin Islands, Guam, American Samoa, the Northern Mariana Islands, and any other possession of the United States. The term local government would include any county, city, town, township, parish, village or other general purpose political subdivision of a State, any combination of these subdivisions that was recognized by HUD and the District of Columbia. In the case of a nominated area on an Indian reservation, the reservation governing body, as determined by Interior, would be deemed to be both the State and local government.

Before designating any area as a rural enterprise zone, HUD would have to promulgate regulations, after consultation with the above Federal officials, describing (1) the nomination procedures, (2) the size and population characteristics of a rural enterprise zone, and (3) the procedures for comparing nominated areas using the criteria specified below for evaluating commitments made by State and local governments and for establishing priorities to be applied in making designations.

HUD could designate rural enterprise zones only during a 36-month period that began on the later of the first day of the first month after the effective date of the regulations, or January 1, 1988. No more than 45 rural enterprise zones could be designated under this provision, and no more than 18 zones during the first 12-month period it was effective.

HUD could not designate an area as a rural enterprise zone unless the local government and the State in which the nominated area was located had the authority to nominate, to make commitments with respect to the zone, and to assure that the commitments would be fulfilled. HUD also would have to determine that the information submitted with a nomination was reasonably accurate and that no portion of the nominated area was already included in a rural enterprise zone.

Period designation in effect

Any rural enterprise zone designation would remain in effect from the date of designation to the earliest of December 31 of the calendar year 12 years later, the date stipulated by the State and local governments in their nomination application, or the date the zone designation was revoked by HUD. No designation would take effect until the relevant State or local government submitted to HUD an inventory of historic propoerties within the area. HUD, after consulting with the same Federal officials who would be required to be consulted in designating rural enterprise zones, could revoke a zone designation if it determined that the State or local government was not substantially complying with the required State or local government commitments (described below).

Area and eligibility requirements

HUD could designate an area nominated as a rural enterprise zone, only if it met requirements concerning size, population, area boundaries, unemployment, poverty and other signs of economic distress. A description of these requirements follows:

a. The area would be required to have a continuous boundary and be either (1) within a local government jurisdiction or jurisdictions that were not central cities of a metropolitan statistical area and that have a population of less than 50,000, (2) outside of a metropolitan statistical area, or (3) determined by HUD (after consultation with the Secretary of Commerce) to be rural.

b. The most recent census would be required to show that the area's population was at least 1,000, or the area was entirely within an Indian reservation.

c. The nominating governments would be required to certify that the area was one of pervasive poverty, unemployment and general distress, and was located wholly within a jurisdiction which met the requirements for Federal assistance under section 119 of the Housing and Community Development Act of 1974, as in effect on the date of enactment. In addition, the area would be required to be one in which either (1) the unemployment rate was at least 1-1/2 times the national national unemployment rate, (2) the poverty rate was at least 20 percent, or (3) at least 70 percent of the households living in the area had incomes below 80 percent of the median income of households within the jurisdiction of the local government.

Required State and local government commitments

No area could be designated as a rural enterprise zone unless the local government and the State in which it was located agreed that, during any period that the area was a rural enterprise zone, these governments would follow a specified course of action designed to reduce the various burdens by employers or employees in the area.

This course of action could be implemented by the State and local governments and private nongovernmental entities, and could be funded from the proceeds of any Federal program. The course of action could include, but would not be limited to, (1) a reduction of tax rates or fees applying within the rural enterprise zone; (2) an increase in the level or efficiency of local services within the rural enterprise zone, particularly through experiments with the supply of these services by nongovernmental entities; (3) elimination, reduction or simplification of governmental requirements applying within the rural enterprise zone; and (4) program involvement by private entities, organizations, neighborhood associations and community groups, particularly those within the nominated area (including a commitment from these private entities to provide technical, financial or other assistance to, and jobs or job training for, employers, employees and residents of the area).

Priority of designation

The bill would provide criteria for HUD to use in choosing areas to be rural enterprise zones. HUD would be required to give special preference to those nominated areas for which contributions to a course of action (as described above) had been promised by the nominating governments, taking into account their fiscal ability to provide tax relief. HUD also would be required to give preference to nominated areas with the following characteristics: (1) strongest and highest quality contributions; (2) most effective and enforceable guarantees provided by nominating State and local governments that proposed courses of action actually would be carried out for the duration of the designation; (3) high levels of poverty, unemployment and general distress, particularly areas near concentrations of disadvantaged workers or long-term unemployed individuals for whom employment would be a strong likelihood if the area were designated a rural enterprise zone, (4) zone size and location that would primarily stimulate new economic activity and minimize unnecessary Federal tax losses; (5) most substantial commitments by private entities of additional resources and contributions, including creation of new or expanded business activities; and (6) nominated zones which best exhibited such other factors that would be consistent with the program's intent and important in minimizing unnecessary loss of Federal tax revenues.

Evaluation and reporting requirements

HUD would be required to prepare and submit to Congress a report on the effects of designating qualifying areas as rural enterprise zones in accomplishing the purposes of the legislation not later than the close of the fourth calendar year after the year in which areas are first designated as rural enterprise zones. Subsequent reports would be submitted at four year intervals.

Interaction with other Federal programs

Any reduction of taxes under any required program of State and local commitment under the bill would be disregarded in determining the eligibility of a State or local government for, or the amount or extent of, any assistance or benefits under any Federal law. In addition, the designation of a rural enterprise zone would not consitute approval of a Federal program for purposes of the Uniform Relocation Assistance and Real Property Acquisition Policies Act of 1970 or entitle any person displaced from real property in such zone to any rights or benefits under such Act. Such a designation also would not constitue a Federal action for purposes of applying the requirements of the National Environmental Policy Act of 1969 or other provisions of the law relating to the protection of the environment.

Tax incentive provisions

Wage tax credit

The bill would provide a 10-percent tax credit for employers in designated rural enterprise zones, for certain wages paid to qualified employees. Only the amount of wages paid by an employer in designated rural enterprise zones during a specified 12-month period, which exceeded the wages paid by that same employer during the immediately previous 12-month period, would qualify for the credit. In no event, however, would qualified wages with respect to a qualified employee exceed an amount equal to the lower living standard for a family of four as determined by the Bureau of Labor Statistics for the applicable year. The bill also would provide for an annual inflation adjustment to the qualified wage base amount and the living standard. Qualified wages for purposes of this credit generally would constitute the definition of wages currently applicable Federal unemployment (FUTA) tax purposes, with certain adjustments. One such modification would be the exclusion from the wage base of any Federally funded payments the employer received or accrued for on-the-job training. A second difference would relate special rules for agricultural and railway labor.

For purposes of the credit, an individual would be required to satisfy a two-part test to become a qualified employee. The first part of the test would require that at least 90 percent of the services of the employee during the taxable year be directly related to the conduct of the employer's trade or business which was located in the rural enterprise zone. The second part of the test would require that the employee perform at least 50 percent of the services during the taxable years in the rural enterprise zone.

Capital gains and losses

If the taxpayer sold or exchanged qualified rural enterprise zone property and within twelve months used the proceeds to purchase other such property, the bill would permit the taxpayer to elect nonrecognition treatment of his gain or loss on the sale or exchange. The bill defines qualified rural enterprise zone property as any tangible personal property used predominantly by the taxpayer in his business within a designated rural enterprise zone or any real property located within the zone and used by the taxpayer in his business. Any such property would be required to be placed in service by the taxpayer while the designation of the enterprise zone was in effect.[4]

Any property which qualified for this nonrecognition treatment, would remain qualified if the designation of the zone expired or was revoked. However, after the first sale or exchange of qualified property following the designation of the zone had expired or been revoked, the property would cease to be qualified.

If the taxpayer elected nonrecognition treatment, he or she would be required to adjust the basis of the new property downward by the amount of the gain not recognized, or upward by the amount of the loss not recognized.

Private activity bonds

The bill would permit qualified property which was financed with the proceeds of tax-exempt bonds to use the accelerated cost recovery system which would apply in the absence of tax-exempt financing in lieu of the alternative depreciation system which generally requires straight-line depreciation over longer recovery periods for tax-exempt bond-financed property.

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[4] The bill defines a "rural enterprise zone business" as one which generated at least 80 percent of its gross receipts from activities carried on within the zone, and had substantially all of its tangible assets located within the zone. It appears the intent of the bill is to define interests in these businesses as qualified property for the purpose of capital gain nonrecognition.

Present law establishes a sunset date of December 31, 1989, for the issue of qualified small-issue manufacturing facility bonds. The bill would revoke the sunset date as it applies bonds funding facilities in a rural enterprise zone, if the facilities were placed in service while the zone designation was in effect. The bill also would permit qualified small-issue bonds to have face amounts in excess of $1,000,000 or $10,000,000 if 95 percent of the proceeds were used to finance facilities within a rural enterprise zone. However, no one beneficiary could receive within an enterprise zone the benefit of more than $40,000,000 from tax-exempt financing over a three-year period.

The bill would require each State which had at least one designated rural enterprise zone to allocate at least five percent of its annual private activity bond volume authority for use within its enterprise zone or zones.

Tax simplification

The bill would provide that it is the sense of the Congress that the Treasury Department simplify the administration and enforcement of any provisions of the Internal Revenue Code of 1986, amended by this bill, as applied to rural enterprise zones.

Other provisions

Regulatory flexibility

The bill would expand the definition of a small entity, for purposes of the Regulatory Flexibility Act, to include any qualified rural enterprise zone business, any government designating an area as an enterprise zone to the extent any regulatory rule would affect the zone, and any not-for-profit enterprise operating within such a zone.

Under the bill, Federal agencies and regulatory bodies would be given discretionary authority to relax or eliminate any regulatory requirements within enterprise zones except those affecting civil rights, safety and public health, or those required by statute, including any requirement of the Fair Labor Standards Act. This authority could be exercised only upon request of State and local governments. Agencies would make their determinations on requests not later than 90 days after their receipt. Such waivers or determinations would not be considered a rule, rulemaking, or regulation under the Administrative Procedure Act.

Coordination of Housing and Urban Development programs in enterprise zones

The bill would provide that HUD would be required to promote the coordination of programs under its jurisdiction and carried on in an enterprise zone and to consolidate requirements for related applications and reports required under these programs.

Establishment of foreign trade zones in rural enterprise zones

The bill would require the Foreign-Trade Zone Board to expedite on a priority basis the processing and approval of any application involving the establishment of a foreign trade zone within a rural enterprise zone. The Treasury Department would be required to give the same urgent consideration to an application for establishment of a port of entry (necessary to permit the establishment of a foreign trade zone within a rural enterprise zone). The bill would direct the Foreign-Trade Zone Board and Treasury, in evaluating applications for the establishment of foreign-trade zones and ports of entry in connection with rural enterprise zones, to approve the applications to the maxiumum extent practicable consistent with their respective statutory responsibilities.

Responsibilities of Federal agencies

The bill would provide that Federal agencies must provide special assistance to rural enterprise zones to the extent permitted by law. Such assistance could include (but would not be limited to) expedited processing, priority funding, program set-asides, and provision of technical assistance. The heads of Federal agencies would be directed to prescribe such regulations as might be necessary or appropriate to carry out the bill's purposes.

Effective date

The bill generally would be effective after December 31, 1986.

III. DESCRIPTION OF S. 1781

A. Present Law

Deduction for charitable contributions--General rules

A deduction is permitted for contributions of cash or property to or for the use of charitable organizations, the United States, or a State or local government (Code sec. 170). The maximum amount of charitable deduction allowable for any one year is subject to limitations generally based on adjusted gross income (in the case of an individual), depending on the nature of property donated and the type of donee organization, or on taxable income (in the case of a corporation), determined in each case without regard to certain deduction items. Contributions in any one year in excess of these limits may be carried forward and deducted over the following five years (subject to applicable percentage limitations in those years).

If appreciated property is contributed, the deduction amount (for purposes of the regular tax) generally equals the fair market value of the property on the date of the contribution. This rule would apply, for example, in the case of a contribution of appreciated stock to a publicly supported charity if the sale of that stock by the donor would have given rise to long-term capital gain. However, to the extent that a sale of the appreciated property by the donor would not have given rise to long-term capital gain (or in certain other situations), the deduction is reduced (sec. 170(e)(1)(A)). For example, the sale of a debt instrument by a bank or certain other financial institutions generally is not considered a sale or exchange of a capital asset (sec. 582(c)). Thus, a charitable contribution of an appreciated debt instrument by a bank would result in a deduction only to the extent of the donor's basis in the instrument.

If a taxpayer sells property to a charitable organization for less than its fair market value--a so-called "bargain sale"--the basis of the property is allocated between the portion of the property "sold" and the portion of the property "donated" to the charity based on the ratio of the sale proceeds to the fair market value of the property (sec. 1011(b)). The proceeds of the sale are treated as taxable gain or loss to the extent of the difference between the sales proceeds and the basis allocated to the sale. The seller is allowed a charitable contribution deduction (subject to the usual rules for donations of property) for the value of the portion of the property "given" rather than "sold." For example, if a taxpayer sold property with a fair market value of $100, and basis of $20, to a charity for $50, half of the property (with basis equal to $10) would be treated as having been sold to the charity for $50, and half of the property (with fair market value of $50) would be treated as having been donated to the charity.

If a taxpayer makes a charitable contribution of depreciated property, the deduction amount is generally limited to the fair market value of the property on the date of the contribution. Absent a bargain sale, a charitable contribution generally does not constitute a disposition giving rise to taxable gain or loss on the property. Thus, a contribution of property generally does not result in the recognition of the inherent gain or loss that the donor would have realized had the donor sold the property. If a taxpayer owns depreciated property the sale or abandonment of which would give rise to a deductible loss, a charitable donation of such property may produce a smaller deduction (i.e., the fair market value of the property) than would result from sale or abandonment of the property. For example, an abandonment may result in a deduction equal to the basis of the property (sec. 165). As another example, a sale of property at a loss may give rise to a deductible loss equal to the difference between the taxpayer's basis in the property and the sale proceeds; a charitable contribution of the sale proceeds could result in a charitable deduction which, together with the loss deduction, allows the entire basis to be deducted.

Revenue Ruling 87-124

The IRS recently ruled that under certain circumstances the delivery of a depreciated debt obligation to the debtor, followed by receipt of consideration by a charitable organization (rather than the former holder of the obligation), will result for tax purposes in both a loss to the holder and a deductible charitable contribution by the holder. Under the ruling, the sum of the loss and the contribution will equal the holder's adjusted basis in the obligation. Rev. Rul. 87-124 (released Nov. 12, 1987), 1987-47 I.R.B.

The ruling assumes that a foreign country (FC) has a program under which a holder of a U.S. dollar denominated debt obligation of FC can deliver the obligation to FC's central bank in exchange for FC's local currency if the holder agrees to use the currency in FC in a manner approved in advance by the government of FC. In accordance with a prearranged plan pursuant to this program, a U.S. bank holding a dollar obligation of FC's central bank, with an adjusted basis of $100, delivers the obligation to the central bank. The latter credits an account of a U.S. charitable organization with 900 units of local currency. The free market exchange rate at the time is $1 = 10 units of the local currency. The charity can only use the currency in FC for charitable purposes meeting the requirements of Code section 170. The ruling suggests that such a restriction may reduce the fair market value of the 900 units below $90.

The ruling states that the U.S. bank recognizes a loss on the exchange of the obligation for 900 units of local currency to the extent of the excess of $100 over the fair market value of the currency; further, if the bank and the charity otherwise satisfy all requirements of the Code relating to charitable contributions, the bank is entitled to a charitable contribution deduction equal to the fair market value of the local currency at the time of the contribution.

Qualified conservation contributions

Subject to certain exceptions, no charitable deduction is allowed for contributions of less than the taxpayer's entire interest in the donated property. This restriction does not apply with respect to donations of "qualified conservation contributions," defined as certain interests in real property (such as permanent restrictions on the use which may be made of real property) short of absolute fee interests, if made to certain types of charitable organizations exclusively for conservation purposes (sec. 170(h)).

Information return by donee on disposition of contributed property

If a donee charity sells, exchanges, transfers, or otherwise disposes of any charitable deduction property within two years of the date it received the property, the donee must furnish the IRS with an information return containing the donor's name, address, and tax identification number, a description of the property, the dates of its contribution and disposition, and the amount received on disposition (sec. 6050L). Charitable deduction property is any property other than publicly traded securities (securities for which market quotations are readily available on an established securities market) the contribution of which gave rise to a claimed charitable deduction greater than $5,000.

B. Explanation of the Bill

General rules

The bill would provide that in the case of qualified debt contributions, the amount of any charitable deduction otherwise allowable will be no less than the donor's basis in the contributed debt instrument. Such a deduction is subject, under the bill, to the existing percentage limitations on charitable contributions in any taxable year. Thus in the case of a depreciated debt instrument held by a bank and donated as qualified debt contribution pursuant to the bill, the bank could deduct as a charitable contribution (subject to the percentage limitation) an amount equal to the combined loss and charitable deductions that would have been available had the bank that first sold the instrument at a loss and then donated the proceeds to charity.

Other tax consequences may be different, however. For example, in the case of a loss sale followed by a contribution of the sale proceeds, only the proceeds of the sale are subject to the percentage limitations on charitable contribution deductions.

A qualified debt contribution is defined under the bill as a contribution of a certain type of debt instrument to a qualified organization with respect to which the taxpayer receives from the donee a written statement that the instrument (or the proceeds therefrom) will be used for an international conservation purpose.

The contributed debt instrument must evidence a loan to certain foreign states eligible for World Bank or International Development Association financing. It is intended that a country be included in the eligible category if it is a "Part II" member of the International Development Association (IDA). Currently there are approximately 114 members in this category, which includes the IDA members whose subscriptions and contributions to IDA may not be used by IDA for projects financed by IDA and located outside the territories of the member (except by agreement between the member and IDA).

The bill defines "qualified organization" by reference to existing law applicable to qualified conservation contributions, i.e., to mean certain types of public charities and Federal, State, or local governments (sec. 170(h)(3)).

Donation purpose

An international conservation purpose means the expenditure in or with respect to the country that is either the obligor of the debt instrument or the residence of the obligor, for one or more of the following purposes:

(1) the preservation of land areas for outdoor recreation by, or the education of, the general public;

(2) the protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem;

(3) the support of museum, park, conservation, and nature and conservation education personnel and programs;

(4) the facilitation of cohabitation between inhabitants of a particular area and fish, wildlife, plant, or similar

ecosystems in the area;

(5) research and experimentation in connection with any of the purposes described above; and

(6) support of international, national, and local governmental programs to accomplish any of the above purposes.

Information returns

The bill also provides that the rules requiring donees to file information returns regarding their dispositions of certain donated property would not apply to the redemption of a qualified debt instrument that qualifies for deduction under the bill.

Effective date

The amendments made by the bill would apply to contributions after the date of enactment.

STATEMENT OF SENATOR KIT BOND

HEARING ON NOVEMBER 13, 1987 BEFORE THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT OF THE SENATE FINANCE COMMITTEE

MR. CHAIRMAN AND MEMBERS OF THE SUBCOMMITTEE. I APPRECIATE THE OPPORTUNITY TO TESTIFY TODAY BEFORE YOUR SUBCOMMITTEE IN STRONG SUPPORT OF S.983, LEGISLATION INTRODUCED BY SENATOR DANFORTH WHICH WOULD ESTABLISH FEDERAL RURAL ENTERPRISE ZONES. I AM AN ORIGINAL COSPONSOR OF THIS BILL.

TODAY'S HEARING IS PARTICULARLY RELEVANT IN LIGHT OF SENATE PASSAGE LAST EVENING OF THE CONFERENCE REPORT ON THE HOUSING AUTHORIZATION BILL. THE LEGISLATION PROVIDES FOR THE DESIGNATION OF 100 ENTERPRISE ZONES, WITH A REQUIREMENT THAT A MINIMUM OF ONE THIRD OF THE DESIGNATIONS BE MADE IN RURAL AREAS.

I HAVE LONG BEEN A SUPPORTER OF ENTERPRISE ZONES. DURING MY SECOND TERM AS GOVERNOR, I WORKED FOR AND EVENTUALLY SIGNED INTO LAW A BIPARTISAN PROPOSAL WHICH ESTABLISHED THE PROGRAM IN MY STATE. LIKE S. 983, IT REQUIRES CITIES AND TOWNS TO MEET RELEVANT ECONOMIC NEED AND UNEMPLOYMENT CRITERIA IN ORDER TO RECEIVE THE ENTERPRISE ZONE DESIGNATION. ONCE DESIGNATED, A BUSINESS CAN CLAIM AN INVESTMENT TAX CREDIT AGAINST ITS STATES TAXES FOR 10 YEARS. A COMPANY CAN ALSO TAKE $1200 IN TAX CREDITS FOR EACH JOB IT CREATES FOR UNEMPLOYED INDIVIDUALS WHO LIVE IN THE ENTERPRISE ZONE AND $400 PER PERSON IF IT HAS TO PROVIDE SPECIALIZED TRAINING. FINALLY, HALF OF A NEW COMPANY'S INCOME IS ELIGIBLE FOR AN EXEMPTION FROM STATE TAX FOR UP TO 15 YEARS.

THE MISSOURI PROGRAM HAS BEEN A TERRIFIC SUCCESS. TO DATE, 33 ENTERPRISE ZONES HAVE BEEN DESIGNATED, RESULTING IN 8000 NEW JOBS ACROSS THE STATE AND OVER $200 MILLION IN INVESTMENT IN NEW PLANTS

AND EQUIPMENT. I UNDERSTAND THAT YOU WILL BE HEAR TESTIMONY LATER ON ABOUT ONE OF THE PROGRAM'S GREATEST SUCCESS STORIES- THE TOWN OF CUBA, MISSOURI. WE IN THE STATE ARE VERY PROUD OF WHAT THAT TOWN HAS ACCOMPLISHED. I AM PLEASED THAT DENNIS ROEDEMEIER, PRESIDENT OF ITS INDUSTRIAL BOARD, IS HERE TODAY TO DESCRIBE ITS ACHIEVEMENTS.

OUR COUNTRY'S RURAL AREAS HAVE TAKEN A BEATING OVER THE PAST SEVERAL YEARS. THEY ARE AN IMPORTANT PART OF OUR ECONOMIC AND SOCIAL FABRIC AND MUST NOT BE ABANDONED. I VIEW ENTERPRISE ZONES AS A PRACTICAL AND VALUABLE TOOL FOR HELPING TO REVITALIZE OUR RURAL ECONOMY. I URGE THE SUBCOMMITTEE TO GIVE S. 983 ITS SERIOUS CONSIDERATION.

THANK YOU, MR. CHAIRMAN.

TESTIMONY OF OLEG CASSINI

Good morning, my name is Oleg Cassini and I am pleased to be testifying before you today on such an important issue. The reason that this legislation is important to me is that I have had an interest in Native Americans and their culture for many years.

Almost 30 years ago, President John F. Kennedy asked me to become his Commissioner of the Bureau of Indian Affairs. I turned down the President because at that time I simply had to devote my time to running my business, but I offer this anecdote by way of illustrating my abiding interest in Indian Affairs.

I have an extra special feeling for the Navajo people. Almost thirty years ago I spent time in the Navajo Nation. The Reservation was as beautiful as any place I had ever seen. And the Navajo people, in their artistry and temperament, reminded me of my own Italian ancestry. Due to my attraction to Navajo, I wanted to work with the Navajo people.

Unfortunately, thirty years ago, the Navajo people and their trustee in Washington were not ready to work with the private sector. Understandably, the Navajo did not trust the private sector and did not know the positive role that private enterprise this town prepared at that time to encourage economic self-sufficiency among their "wards," the Indians.

Things have changed. Approximately six months ago, I had the pleasure of meeting the man that sits beside me on this panel, Navajo Chairman Peter MacDonald. We met for dinner and he told me of his goals, dreams and aspirations for his people. At his invitation, I ventured to Tohatchi, New Mexico to the Navajo Economic Summit for a remarkable day of discussion. My dream of working with the Navajos was rekindled, because I truly believe the will to succeed and the means to succeed are now there.

At Chairman MacDonald's invitation, I am now assisting the Navajo Nation in the development of a world-class resort on the Reservation. This resort will be designed to highlight Navajo traditions and culture, and to give visitors a sustained look at all the wonders to be found throughout the Reservation. The rooms will be decorated with Navajo furnishings. Navajo fashions will be sold in the shops. I now look forward to my new partnership with Chairman MacDonald and the Navajo people. This project should provide hundreds of Navajo with jobs and income. Due to the natural beauty of the Reservation, I believe they are capable of competing with anyone in the area of tourism without assistance.

Even though much has changed on the Reservation since my first visit there decades ago, certain things remain the same. Indian people are still poorer and unhealthier than the rest of the American population. Their rates of alcoholism are higher than the rest of American society. To rectify these problems, Indian people require immediate help from the Federal Government. As I said at the Navajo Summit, the Navajos future has every reason to be bright. But, to keep morale high, and to keep economic development moving forward, Navajo people need to see some meaningful progress.

Besides the resort project, Chairman MacDonald is talking to several other prospects interested in locating manufacturing facilities at Navajo. The Congress should support the Navajo's effort by enacting this landmark piece of legislation, the Indian Economic Development Act. As I said before, Navajo is fully competitive in the area of tourism. This bill would help Navajo compete in the area of manufacturing. This is where Indian tribes are at a competitive disadvantage and where I believe the Federal Goverment needs to provide assistance.

While I am not a tax lawyer, I understand business. Private enterprise will make their site locations based on where they can make the most money. If the legislation that we are discussing today were passed, business would be more likely to go to Navajo because of the tax credits they would receive. I would ask the members of this Committee to think about what passage of this legislation would do for the Navajo people. Maybe only one factory would locate at Navajo. Think of what that would do for the welfare and morale of the people. Perhaps 200 jobs would be created. I believe that the Navajos need a victory. Without one, I am fearful that the people will once again shun business and go back to distrusting the private sector. Hopefully, the Congress will allow human needs to guide their deliberations of this legislation.

There is something that I know more about than Indian Affairs. I have spent my entire professional life in the fashion industry. Thirty years ago, much of the textiles and apparel sold in this country was produced in the U.S. Today, fashions bearing my label are produced in several countries. Almost 66 percent of the garments and textiles sold in the U.S. are imported. Thousands of American jobs have been exported offshore, attracted by the tax, labor and other incentives the so-called newly industrializing countries have to offer. Economists have different explanations for these developments. Some believe that the over-valued dollar of the 1980s which made imports cheaper and exports more expensive was responsible for the woes of the garment and textile manufacturers. Others believe that foreign imports are of higher quality.

I believe that cost considerations are the major factors for these developments. Countries in Asia such as Singapore, Hong-

Kong, Taiwan and China can afford to sell their products cheaply. These countries offer companies many tax breaks which allow them to significantly reduce production costs. Additionally, some of these countries permit wages to workers of 50 cents an hour and less. These are the reasons that we import so many foreign goods. The quality of goods produced by American workers is comparable to that of foreign-made goods. But, American industry cannot compete with foreign labor rates and tax subsidies.

I do not like to see Oleg Cassini's products produced overseas. My products should be produced in the U.S. by our workers. Preferably, I'd like to see my products produced by Navajo. If the costs were right, I could open a factory on the Navajo reservation. After all, for any of you who have seen the quality of Navajo weaving, you know they are perfectly capable of producing the highest quality textiles and most innovative designs in the world.

If this legislation were passed, and tax incentives offered to manufacturers such that costs could be brought down to a level competitive with overseas, I know my colleagues in this industry and many others would look seriously at locating at Navajo. Is not this what the Federal Government should try to do for our Native Americans?

I enjoyed discussing these issues with you today. We owe a great deal to Indians. The Navajo people and Chairman MacDonald cannot do it alone. They need help from the government. Remember, I said that these people need a quick win. Whereas this bill might be a small part of what Navajo and other tribes require, it might help them win one. Please think of this when you consider the legislation.

STATEMENT BY
SENATOR JOHN H. CHAFEE
BEFORE THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
OF THE SENATE FINANCE COMMITTEE
NOVEMBER 13, 1987

I AM DELIGHTED THAT WE ARE HERE TODAY TO EXPLORE THE MERITS OF A BILL WHICH SENATOR MITCHELL AND I INTRODUCED EARLIER THIS YEAR, S. 1781. SENATOR BOREN IS ALSO A COSPONSOR. I WOULD LIKE TO THANK SENATOR BAUCUS, THE CHAIRMAN OF THIS SUBCOMMITTEE AND SENATOR BENTSEN, THE CHAIRMAN OF THE FULL COMMITTEE FOR HOLDING A HEARING ON THIS MEASURE IN SUCH A TIMELY MANNER.

THIS BILL EMBODIES A RATHER INGENIOUS IDEA ON HOW TO HELP DEVELOPING NATIONS CONVERT A PORTION OF THEIR GROWING DEBT INTO CONSERVATION PROGRAMS. THE GROUP WHICH FIRST APPROACHED ME WITH THIS IDEA WAS THE WORLD WILDLIFE FUND, IN THE PERSON OF DR. THOMAS E. LOVEJOY, THE EXECUTIVE VICE PRESIDENT. DR. LOVEJOY WILL BE TESTIFYING HERE TODAY IN SUPPORT OF THE LEGISLATION AND HAS DONE AN ENORMOUS AMOUNT OF WORK TO ENACT THIS VERY CREATIVE PROPOSAL.

IN ADDITION TO THE WORLD WILDLIFE FUND, THERE ARE A NUMBER OF OTHER ENVIRONMENTAL GROUPS SUPPORTING THE MEASURE AND I WOULD LIKE TO INSERT IN THE RECORD A LETTER OF SUPPORT SIGNED BY THE FOLLOWING OTHER ENVIRONMENTAL GROUPS: ENVIRONMENTAL DEFENSE FUND; NATURAL

RESOURCES DEFENSE COUNCIL; INTERNATIONAL INSTITUTE FOR ENVIRONMENT AND DEVELOPMENT; THE NATURE CONSERVANCY; NATIONAL AUDUBON SOCIETY; NEW YORK ZOOLOGICAL SOCIETY; NATIONAL WILDLIFE FEDERATION; AND THE SIERRA CLUB, PLUS A SEPARATE LETTER SIGNED BY CONSERVATION INTERNATIONAL.

THE BILL WOULD PERMIT BANKS WHO DONATE THIRD WORLD DEBT TO INTERNATIONAL CONSERVATION ORGANIZATIONS TO A CHARITABLE CONTRIBUTION DEDUCTION EQUAL TO THEIR BASIS IN THE DEBT.

UNDER CURRENT LAW, IF THE BANK DONATES ANY OF THIS THIRD WORLD DEBT TO A CHARITABLE ORGANIZATION, THE BANK MAY TAKE A DEDUCTION FOR THE FAIR MARKET VALUE OF THE DEBT -- WHICH UNFORTUNATELY IS OFTEN FAR LESS THAN THE BANK'S BASIS IN THE DEBT. THIS BILL WOULD ACTUALLY JUST PUT THE BANK IN THE SAME SITUATION IT WOULD HAVE BEEN IN HAD IT SOLD THE DEBT (AT A LOSS), AND THEN DONATED THE PROCEEDS TO THE CHARITY.

WE ARE ALL TOO FAMILIAR WITH THE VERY DIFFICULT PROBLEMS FACING MANY OF THE DEVELOPING NATIONS AS A RESULT OF THE SO-CALLED "THIRD WORLD DEBT CRISIS." WE HAVE LEARNED THAT IN ADDITION TO BEING A SIGNIFICANT HANDICAP TO THE ECONOMY OF THE DEVELOPING NATION ITSELF, THE EXISTENCE OF THESE HUGE DEBTS ALSO HAS RAMIFICATIONS FOR OUR BALANCE OF TRADE, THE SOUNDNESS OF OUR

FINANCIAL INSTITUTIONS, AND THE GENERAL POLITICAL STABILITY OF THESE DEVELOPING COUNTRIES.

THE BILL WE ARE EXAMINING TODAY IS NOT GOING TO SOLVE THE THIRD WORLD DEBT CRISIS, BUT IT IS AN EXAMPLE OF TAKING A VERY BAD SITUATION AND SALVAGING A LITTLE GOOD OUT OF IT.

IN THE MIDST OF THIS DEBT CRISIS, IT IS VERY DIFFICULT FOR A DEVELOPING NATION TO SPEND MONEY ON THE ENVIRONMENT -- ON PARKS OR PRESERVING THE RAIN FORESTS -- WHEN THERE ARE MANY OTHER COMPETING HUMAN NEEDS THAT MUST BE MET. INTERNATIONAL ENVIRONMENTAL GROUPS ARE WELL AWARE OF THIS DILEMMA, AND THEY HAVE DEVELOPED AN IMAGINATIVE WAY TO HELP DEVELOPING NATIONS IMPLEMENT AND MAINTAIN CONSERVATION PROGRAMS.

A RECENT ARTICLE IN THE AUGUST 31, 1987 ISSUE OF NEWSWEEK, ENTITLED "BUYING DEBT, SAVING NATURE" DESCRIBES WHAT THESE ENVIRONMENTAL GROUPS ARE DOING:

> IN 20 YEARS THE FOREST OF THE TROPICS WILL BE LARGELY STRIPPED BARE UNLESS THIRD WORLD COUNTRIES SLOW THEIR RAVENOUS LOGGING AND MINING. COUNTLESS SPECIES OF PLANTS AND ANIMALS WILL DIE IN "THE GREATEST EXTINCTION SINCE THE END OF THE AGE OF THE DINOSAURS." BUT BIOLOGY LECTURES CARRY LITTLE CLOUT WITH

POOR COUNTRIES DESPERATE FOR CASH TO PAY HUGE FOREIGN DEBTS. NOW U.S. ENVIRONMENTAL GROUPS ARE MAKING AN IMAGINATIVE OFFER TO THIRD WORLD GOVERNMENTS: WE'LL PAY YOUR DEBTS IF YOU'LL SPARE YOUR TREES.

IN THE SO-CALLED "DEBT FOR NATURE" SWAPS, CONSERVATION ORGANIZATIONS ACQUIRE THIRD WORLD DEBT FROM U.S. BANKS AND NEGOTIATE WITH A THIRD WORLD COUNTRY TO REDEEM THE DEBT IN LOCAL CURRENCY WHICH IS THEN USED FOR A CONSERVATION PROGRAM IN THAT COUNTRY. CONSERVATION ORGANIZATIONS BELIEVE THAT DEBT FOR NATURE SWAPS PROVIDE A SIGNIFICANT OPPORTUNITY FOR LEVERAGING A RELATIVELY SMALL DONATION INTO A MUCH LARGER SOURCE OF CAPITAL FOR CONSERVATION PROGRAMS. BECAUSE THE FUNDS ARE BEING USED FOR A LOCAL CONSERVATION PURPOSE, FOREIGN COUNTRIES ARE WILLING TO REDEEM THEIR DEBT FROM CONSERVATION ORGANIZATIONS FOR AMOUNTS IN EXCESS OF THE PRICES AT WHICH THE DEBT IS TRADED IN U.S. MARKETS.

TWO RECENT TRANSACTIONS ILLUSTRATE THE EXTRAORDINARY POTENTIAL OF THESE INNOVATIVE PROGRAMS. CONSERVATION INTERNATIONAL, A WASHINGTON-BASED ORGANIZATION, HAS AGREED TO BUY $650,000 OF BOLIVIAN DEBT FROM BANKS AT A DISCOUNTED PRICE OF $100,000. IN RETURN FOR THE REDEMPTION OF THAT DEBT, BOLIVIA WILL SET ASIDE 3.7 MILLION ACRES OF FOREST AND GRASSLANDS OF AMAZON RIVER COUNTRY AROUND THE EXISTING BENI BIOSPHERE RESERVE, WHICH PROTECTS ENDANGERED SPECIES OF CATS AND MONKEYS.

IN ANOTHER RECENT TRANSACTION, WORLD WILDLIFE FUND OF WASHINGTON, DC, HAS AGREED TO PURCHASE $270,000 OF COSTA RICA'S FOREIGN DEBT FOR $100,000. THE DEBT WILL THEN BE REDEEMED BY COSTA RICA AND THE PROCEEDS USED TO PURCHASE 40,000 ACRES OF PARKLAND THAT WILL BECOME PART OF THAT COUNTRY'S NATIONAL PARK SYSTEM. THIS STEP IS ECOLOGICALLY SIGNIFICANT BECAUSE IT WILL PROTECT THE LARGEST FRAGMENT OF TROPICAL DRY FOREST LEFT IN CENTRAL AMERICA.

IN THESE TWO TRANSACTIONS, THE U.S. CONSERVATION ORGANIZATIONS ARE PURCHASING THE DEBT FROM THE HOLDERS OF THE DEBT. MY BILL IS DESIGNED TO ENCOURAGE THE LENDERS OR OTHER HOLDERS TO DONATE THAT DEBT TO THE CONSERVATION ORGANIZATIONS.

EXISTING TAX LAW LIMITS THE CHARITABLE DEDUCTION TO THE MARKET VALUE OF THE LOAN WHEN SUCH VALUE IS BELOW THE FACE VALUE OR THE COST BASIS OF THE LOAN. THUS, IF A LENDER DONATES THIRD WORLD DEBT WITH A MARKET VALUE BELOW ITS COST BASIS TO A CHARITABLE ORGANIZATION, THE LENDER WOULD BE UNABLE TO RECOVER ITS ENTIRE COST BASIS IN THE DEBT THROUGH THE CHARITABLE DEDUCTION.

THIS PLACES THE LENDER IN A WORSE POSITION THAN IF IT HAD SOLD THE DEBT AND DONATED THE PROCEEDS OF THE SALE TO CHARITY. FOR EXAMPLE, IF A LENDER SOLD DEBT WITH A COST BASIS OF $1,000 FOR $500 AND DONATED THE PROCEEDS TO CHARITY, IT WOULD BE ABLE TO DEDUCT A $500 LOSS ON THE SALE AND WOULD ALSO RECEIVE A $500 CHARITABLE

DEDUCTION. IF, ON THE OTHER HAND, IT SIMPLY DONATED THE DEBT TO CHARITY, IT WOULD NOT BE ENTITLED TO A LOSS AND WOULD BE LIMITED TO A $500 CHARITABLE DEDUCTION. IT IS DIFFICULT TO JUSTIFY THAT DISTINCTION.

THE PURPOSE OF THIS BILL IS TO PLACE THE LENDER IN THE SAME POSITION WHEN IT DONATES DEBT TO CHARITY AS IT WOULD HAVE BEEN IN HAD IT SOLD THE DEBT AND DONATED THE PROCEEDS TO CHARITY.

THE TREASURY DEPARTMENT HAS PREVIOUSLY INDICATED SUPPORT FOR THIS PROPOSAL IN A JUNE 25, 1987 LETTER TO DR. THOMAS E. LOVEJOY, FROM SECRETARY OF THE TREASURY, JAMES A. BAKER. (I WOULD LIKE TO PLACE A COPY OF THAT LETTER IN THE RECORD.) THE LETTER ALSO NOTES THAT THE PROPOSAL GIVES SOME FURTHER IMPETUS TO SWAPPING DEBT FOR EQUITY AND FOR DEBT CONVERSIONS WHICH TREASURY HAS ENCOURAGED TO HELP REDUCE DEBT AND DEBT SERVICE BURDENS ON THESE COUNTRIES. FINALLY, THE TREASURY DEPARTMENT ESTIMATED THAT THE REVENUE COST OF THE PROPOSAL IS NEGLIGIBLE.

IN ADDITION TO THIS LETTER, THE TREASURY DEPARTMENT HAS JUST THIS WEEK ISSUED A REVENUE RULING (REVENUE RULING 87-124) WHICH MAY ALLOW THE BANKS TO DO JUST WHAT WE HAVE PROPOSED IN THIS LEGISLATION. I AM LOOKING FORWARD TO HEARING MORE ABOUT THE EFFECT OF THE RULING AND WHETHER IT WILL MEAN THAT LEGISLATION IS NO LONGER NECESSARY. AS FAR AS I AM CONCERNED, IF THE TREASURY

DEPARTMENT RULING WILL PUT THIS PROPOSAL INTO EFFECT, I THINK WE SHOULD ALL DECLARE VICTORY AND REJOICE.

IN SUMMARY, THIS BILL EMBODIES A VERY GOOD IDEA WHICH WILL HELP IN THE FIGHT TO PRESERVE THE WORLD'S ENVIRONMENT FOR GENERATIONS TO COME AND I URGE MY COLLEAGUES AND THE TREASURY DEPARTMENT TO SUPPORT IT.

STATEMENT OF SENATOR DENNIS DeCONCINI

MR. CHAIRMAN AND MEMBERS OF THE SUBCOMMITTEE, THANK YOU FOR ALLOWING ME THIS OPPORTUNITY TO APPEAR BEFORE THE COMMITTEE TO SPEAK ON THE INDIAN ECONOMIC DEVELOPMENT ACT. I COME HERE TODAY TO EXPRESS MY STRONG SUPPORT FOR MY DISTINGUISHED COLLEAGUE, SENATOR McCAIN'S Bill, S. 788.

FIRST OF ALL, I WANT TO COMMEND SENATOR McCAIN FOR HIS VISIONARY LEADERSHIP IN THE ECONOMIC DEVELOPMENT NEEDS OF OUR NATIONS INDIAN RESERVATIONS. HE AND I REPRESENT A STATE WHERE WE HAVE 20 DIFFERENT INDIAN TRIBES. THE TRIBES VARY IN SIZE. THEY HAVE VASTLY DIFFERENT NEEDS. BUT FEW OF THEM HAVE THE RESOURCES WITH WHICH TO DEVELOP THEIR COMMUNITIES.

MANY OF THE TRIBES DO NOT HAVE THE ESSENTIAL INFRASTRUCTURE LIKE TRANSPORTATION SYSTEMS, WATER AND ELECTRICAL SYSTEMS OR THE HOUSING TO ACCOMODATE DEVELOPMENT NEEDS. THEIR LACK OF A TAX BASE MEANS THEY CANNOT RELY ON THE TRADITIONAL MEANS OF RAISING GOVERNMENT REVENUES.

YET THEY HAVE A UNEMPLOYMENT RATES WHICH EXCEED 50 % OF THEIR LABOR FORCE. TRIBAL MEMBERS WHO ARE ABLE AND WANT TO WORK MUST LEAVE THE RESERVATIONS TO FIND WORK. THE YOUNG WHO COMPLETE COLLEGE CANNOT RETURN TO THEIR HOME COMMUNITIES TO CONTRIBUTE TO THE DEVELOPMENT OF THEIR RESERVATIONS. THE LACK OF OPPORTUNITIES LEAVE BEHIND THE DESPAIRING SOCIAL MANIFESTATIONS LIKE ALCOHOLISM AND POOR HEALTH STATUS.

IN THE FACE OF THESE TERRIBLE CONDITIONS, THE NATIVE AMERICAN PEOPLE HAVE NOT LOST HOPE. THEY ASPIRE TO THE SAME DREAMS AS THE REST OF AMERICA. THEY WANT TO WORK. THEY WANT A BETTER FUTURE FOR THEIR CHILDREN. THEY ARE PROUD PEOPLE. THEY WANT TO PROVIDE FOR THEMSELVES. THEY DO NOT WANT TO BE DEPENDENT. THEY WANT TO CONTRIBUTE AND BE A PART OF THIS GREAT NATION.

THIS IS WHAT SENATOR McCAIN IS RESPONDING TO BY PROPOSING S. 788. THIS BILL PROPOSES TO PROVIDE THE INDIAN TRIBES WITH CRITICAL INCENTIVES NEEDED TO ATTRACT PRIVATE SECTOR INVESTMENT IN RESERVATION-BASED DEVELOPMENT ACTIVITIES. THE BILL WOULD ALLOW THE ESTABLISHMENT OF FOREIGN TRADE ZONES. TRIBAL GOVERNMENTS WILL HAVE TO PROVIDE STRONG TRIBAL COMMITMENTS TO ASSURE A STABLE ENVIRONMENT FOR THOSE INDUSTRIES WHICH LOCATE ON RESERVATIONS.

MR. CHAIRMAN, THIS IS A BILL WHICH IS TIMELY. YOU WILL HEAR FROM TRIBES IN MY STATE WHO ARE READY TO MOVE FORWARD. THEY NEED THE INCENTIVES PROPOSED BY THE BILL TO SUCCESSFULLY INITIATE LONG-NEEDED DEVELOPMENT. I URGE THIS COMMITTEE TO CONSIDER THE LONG-TERM BENEFITS WHICH WILL OFFSET ANY IMPACT ON THE REVENUES. IT IS TIME FOR THIS COUNTRY TO WORK WITH THE NATIVE AMERICANS TO BEGIN BUILDING A STONG ECONOMY IN INDIAN COUNTRY.

I URGE THE COMMITTEE'S POSITIVE CONSIDERATION OF S. 788 AND THANK YOU FOR ALLOWING ME TO TESTIFY HERE TODAY.

Dr. Thomas E. Lovejoy

Mr. Chairman,

I am here on behalf of World Wildlife Fund to speak in support of S. 1781 which would amend Section 170 of the Revenue Code to allow a cost basis deduction to banks which make charitable contributions of third world debt for qualifying international conservation purposes.[1/]

I would like to start by thanking you and your staff for scheduling this hearing. I also would like to apologize for the confusion as to whether this hearing was still necessary in light of the issuance on November 12 of Rev. Rul. 87-124 which seeks to provide an administrative solution to the problem. We are still in the process of consulting with tax experts, program staff, and colleagues in Latin America to determine whether the ruling provides as effective a solution as S. 1781. There simply has not been time to complete that review.

Debt-For-Nature Swaps

The deteriorating state of tropical forests in many developing nations deeply concerns us. A high proportion of the world's remaining tropical forests reside in some of the world's most indebted nations. Many of these nations attempt to reduce their debt burdens by clearing forest areas for farmland, pastureland, mining, and timber. By some estimates, at the present rate of conversion the forests of the tropics may be completely destroyed in thirty years.

In 1984, I first proposed swapping third world debt for conservation as a way to slow the trend towards tropical deforestation. At about the same time, a number of debtor nations proposed debt for equity programs through which they planned to redeem portions of their debt in local currency for use in commercial and industrial projects. Lender banks, fearing that many debts (especially in Latin America) might be uncollectible, began to sell high risk debts at substantial discounts. This practice became known as the secondary debt market. World Wildlife Fund, along with other conservation organizations, began a program to buy discounted debts and then redeem their value to provide funds for conservation. Today, we hope to use this "debt for nature" mechanism to affect both the debt and the environmental crises positively.

The prospects for debt for nature swapping are promising. In July of this year, Bolivia entered into the first deal with Conservation Internation (CI). CI purchased and "redeemed" $650,000 of Bolivia's debt at 15 cents to the dollar. By agreement with the President of Bolivia, the Bolivian government, in turn, demarcated 3.7 million acres of tropical forest as a reserve and established a $250,000 fund to manage the area.

Recently, World Wildlife Fund and Fundacion Natura, a private conservation group in Ecuador, agreed to a debt for nature swap involving the purchase of Ecuadoran debt with a face value of at least $1 million. Costa Rica has also announced a debt for nature program in which World Wildlife Fund and other conservation organizations, including The Nature Conservancy, will participate. Under the proposed program, the Central Bank of Costa Rica will redeem up to $5.4 million of its debt by issuing three to five year local currency bonds which will pay no less than 25% annual interest. Proceeds from the bonds in both of these initiatives will finance a variety of conservation projects, including management of existing and new parks, staff support and training, and environmental education.

Along with Ecuador, Costa Rica, and Bolivia, a number of countries have established or expressed interest in debt/equity programs which might be congenial to debt for nature swaps. Countries with formal debt/equity programs include Chile, Mexico, the Philippines, Brazil, and Argentina. Others with potential interest include Peru, Colombia, and the Dominican Republic. Although most countries currently involved with debt/equity issues are in Latin America, World Wildlife Fund hopes to expand its debt for nature program worldwide in collaboration with foreign conservation organizations and commercial interests.

Our proposal to amend Section 170 of the Revenue Code represents an effort to open new possibilities for debt for nature swaps. Presently, a bank that donates debt can deduct only the fair market value of the debt -- generally the amount for which that debt would sell on the secondary market. Under this system, banks have a greater financial incentive to sell their debt, claim a loss deduction, and then donate the proceeds to charity than they have to donate the debt outright. Under this proposed amendment, banks that donate third world debt for conservation will receive a charitable deduction equal to the debt's face value.

This adjustment does not provide financial incentives for banks or debtor countries to unload large amounts of debt onto the market. It simply makes tax considerations a neutral factor in a bank's decision of whether to donate cash or debt for conservation. The cost basis of the deduction is available only if the donation is a qualified debt instrument relating to a specified country, is donated to a section 501(c)(3) organization, and is donated for a qualifying conservation purpose.

In June of this year, Treasury Secretary James Baker declared that providing equal tax treatment for donations of debt and donations of cash is revenue neutral. Without this amendment, banks would continue to donate cash and either sell or hold and write down debt.

We understand there is a concern that, as a matter of policy, a charitable contribution deduction should not be restricted to a donation for a particular purpose. We of course have no objection to expanding the deduction to a donation of debt for any charitable purpose described in section 170(c) provided such an expansion would not result in a revenue loss projection that would affect the bill's prospects for enactment. We also note that tailoring a charitable deduction to a donation for conservation purposes is not novel; section 170(h) of the Internal Revenue Code presently provides a deduction for qualified conservation donations.

Effect of Debt for Nature Swaps

While major banks currently hold large portfolios of third world debt, that debt was issued in fairly small denominations. It is not necessary or even desirable for a bank to donate a large block of debt in order for conservation organizations to achieve their objectives. We want to encourage carefully controlled swaps involving relatively small amounts of debt for specific conservation purposes. The amounts traded will not be large enough to create inflationary pressures in the debtor nations or to affect the interest earnings of the donating bank. These swaps will, however, have a significant positive effect on conservation, where even small amounts of money can achieve substantial results.

We believe that the expansion of our debt for nature program would strengthen the domestic conservation infrastructures of participating debtor countries. By donating conservation funds in the form of debt which can be converted into local currency bonds, banks would support long-term conservation. Experience has taught many conservation organizations that conservation efforts are most effective when handled by the government and the people of the country involved.

World Wildlife Fund and the other organizations we are speaking for today appreciate that the time frame for debt for nature swaps is not open-ended. Debtor countries have only limited funds for swaps, and conservation organizations often must compete in the debt/equity market with commercial and other interests seeking investment opportunities. We also realize that debt-nature swapping will not solve the debt crisis. We believe, however, that debt for nature swaps represent a unique opportunity to support conservation efforts in nations suffering under severe debt burdens.

The Internal Revenue Service and Treasury publicly released Rev. Rul. 87-124 on November 12, 1987 which may lessen or eliminate the need for the legislation.

However, since the ruling was only publicly released yesterday, we have not had an opportunity to assess all its ramifications. We believe the Treasury Department was attempting to provide a helpful administrative solution and we are grateful for those efforts. We would like to submit supplemental testimony after we have completed our review. The ruling relates to the fact pattern where a U.S. commercial bank holds a U.S. dollar denominated debt of the central bank of a foreign country and delivers the obligation to the central bank, which credits an amount of local currency to the account of a U.S. charitable organization for use only in the foreign country for charitable purposes. Under these circumstances, the ruling holds that there are two transactions for tax purposes: an exchange in which loss will be reognized to the extent of the excess of the bank's adjusted basis in the obligation over the fair market value of the foreign currency credited to the charitable organization's account and a charitable contribution deduction equal to the fair market value of the foreign currency. Rev. Rul. 87-124 effectively accomplishes the same result as S. 1781. However, issues have been raised as to whether it would be possible to structure transactions in the manner described in the ruling, and we have not had time adequately to address those issues.

1/ Other conservation organizations that have expressed support for S. 1781 include: Environmental Defense Fund, Natural Resources Defense Council, International Institute for Environment and Development, The Nature Conservancy, National Audubon Society, New York Zoological Society, National Wildlife Federation, Sierra Club and Conservation International.

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December 10, 1987

The Honorable Max Baucus
Chairman
Senate Finance Subcommittee on
Taxation and Debt Management
United States Senate
706 Hart Senate Office Building
Washington, D.C. 20510

Dear Senator Baucus:

The day before the Subcommittee on Taxation and Debt Management's November 13 hearing on S. 1781, Treasury published a revenue ruling (Rev. Rul. 87-124) intended to accomplish the same objective as the proposed legislation, i.e., provide lenders a full cost basis deduction for donations of third world debt to fund charitable activities in the debtor nations. In its hearing testimony, Treasury took the position that the ruling rendered the proposed legislation unnecessary. World Wildlife Fund ("WWF") did not receive the ruling sufficiently before the hearing to determine whether it indeed obviated the need for the legislation. WWF did, however, express concern about certain aspects of the ruling, and Senator Chafee requested that it submit comments for the record after it had had an opportunity more fully to evaluate the ruling. Those comments are presented in this letter.

Rev. Rul. 87-124 describes a transaction in which a U.S. bank holding a U.S. dollar denominated debt obligation ("U.S. debt") of the central bank of a foreign country exchanges the debt for local currency. The central bank credits the local currency to an account of a U.S. charitable organization described in section 170(c)(2) of the Internal Revenue Code. The U.S. charitable organization is required to use the local currency in the foreign country for charitable purposes meeting the requirements of section 170. The ruling concludes that the bank recognizes a loss on the exchange of the U.S. debt for the local currency in an amount equal to the difference between its basis in the debt and the value of the currency and is entitled to a charitable contribution deduction equal to the value of the local currency.

The structure of the transaction described in Rev. Rul. 87-124 is quite different from the structure that would be permitted under the proposed legislation. If S. 1781 is enacted, the bank would be permitted to contribute the U.S. debt directly to the U.S. charitable organization. The organization could then arrange the debt for nature swap without the necessity for further U.S. bank participation.

At the hearing, WWF expressed concern with two aspects of the ruling. The first related to whether structuring the transaction as an exchange of debt with the central bank rather than as a charitable contribution would affect the accounting treatment of the transaction. As a result of discussions with bank financial officers and accounting firms subsequent to the hearings, WWF has concluded that the accounting effect of the exchange and donation described in the ruling should be substantially similar to that of the direct donation contemplated under S. 1781.

The second area of concern is not as readily resolved. The problem arises because the debt for nature swaps that have already been arranged or are currently under consideration do not resemble the transaction described in the ruling. Those swaps generally involve an exchange of U.S. debt acquired by a U.S. charitable organization for debt denominated in the local currency ("L.C. debt"). The L.C. debt may have terms substantially similar to those of the U.S. debt for which it was exchanged. The L.C. debt is generally credited to an entity organized in the foreign jurisdiction rather than to the U.S. charitable organization. Sovereignty concerns of developing countries may make it difficult or impossible to arrange a swap that involves crediting local currency to a U.S. organization as contemplated in the ruling (_see_ attached letter to Marjorie Roberts, Treasury Office of Tax Legislative Counsel, from Kathryn S. Fuller, WWF Executive Vice President and General Counsel). However, if the L.C. debt were credited to a foreign entity in a transaction otherwise structured in accordance with Rev. Rul 87-124, the bank might not qualify for a charitable contribution deduction because section 170(c) permits deductions only for contributions to domestic organizations.

In order for conservation organizations to avail themselves of the ruling in structuring debt for nature swaps, it will be necessary to expand the scope of the ruling. This can be accomplished in two ways. First, Treasury should confirm that an exchange of U.S. debt for L.C. debt (as opposed to the exchange of U.S. debt for local currency) will be treated as a taxable exchange. Second, Treasury should establish guidelines under which the issuance of local currency or L.C. debt to a foreign entity to fund a charitable program in cooperation with a U.S. organization will be treated as a contribution directly to the U.S. organization. These guidelines should be as flexible as possible in order to permit the government of the developing country maximum control in administering expenditures to fund what it would rightfully regard as sovereign functions.

WWF remains hopeful that Rev. Rul. 87-124 may yet prove a useful tool in effecting debt for nature swaps. However, until Treasury provides assurances that it will construe the ruling expansively in order to permit conservation organizations to respect the sovereignty concerns of developing countries, WWF continues to believe that S. 1781 is necessary to foster such swaps.

Sincerely,

Terrill A. Hyde

Terrill A. Hyde

cc: Senator John H. Chafee
Marjorie Roberts, Esq.
Kathryn S. Fuller, Esq.

World Wildlife Fund

November 30, 1987

Ms. Marjorie Roberts
Office of Tax Legislative Counsel
U.S. Treasury Department, Room 4021
15th and Pennsylvania Avenue, NW
Washington, DC 20020

Re: Debt for Conservation Swaps

Dear Marjorie:

This letter responds to your request for information concerning problems that may be encountered in persuading developing countries to fund debt-conservation swaps by crediting local currency to the account of a U.S. charitable organization. Our experiences and those of our counsel, Michael Chamberlin of Shearman & Sterling, lead us to believe that our ability to persuade developing countries to accept such an approach would be problematical.

Our experience has been that countries typically place various restrictions on payment of proceeds; these restrictions are designed to ensure that the proceeds are used in the local country for the approved purpose within the approved time frame. Countries are becoming increasingly sensitive on issues of patrimony and local control. We believe that they can be expected to be particularly sensitive where as here the proceeds would be used to assist with sovereign functions such as the purchase and operation of park land. Many of the local regulations for debt-equity swaps were developed in the context of commercial transactions involving equity investments in which the local currency proceeds of the swap are required to be credited directly to the local company in which the investment is being made. In some cases, disbursements are even further restricted by requiring that proceeds be disbursed only directly to suppliers to, or creditors of, the local company.

Typically, different countries conduct debt-equity transactions in different ways and the rules they use are often not written down. However, we believe, based on prior experience, that the relevant authorities of countries such as Mexico, Chile, Venezuela, Ecuador, the Philippines and Argentina would raise difficulties with and in fact might not approve the crediting of local currency to a U.S. organization. This list is not exhaustive as we have not had experience exploring debt-conservation swaps with many developing countries.

These are some of the major difficulties we believe will arise in structuring swaps to conform to the transaction described in Revenue Ruling 87-124. We hope we will be able to work with you in defining circumstances under which the crediting of local currency to the account of a local entity to further purposes of the U.S. organization will be treated as a contribution to the U.S. organization. We appreciate your cooperation and assistance in this matter.

Sincerely,

Kathryn S Fuller

Kathryn S. Fuller
Executive Vice President
and General Counsel

STATEMENT OF
SENATOR JOHN McCAIN

THANK YOU, MR. CHAIRMAN, FOR HOLDING THIS HEARING TODAY. I APPRECIATE YOUR INTEREST IN INDIAN ISSUES AND, SPECIFICALLY, YOUR INTEREST IN FINDING WORKABLE SOLUTIONS TO THE ECONOMIC PROBLEMS THAT PLAGUE INDIAN COUNTRY.

ON MARCH 19, 1987 I INTRODUCED S.788, ALONG WITH SENATORS INOUYE, EVANS, SIMPSON, DECONCINI, AND BURDICK, TO ESTABLISH ENTERPRISE ZONES ON INDIAN RESERVATIONS. SUCH ZONES WOULD PROVIDE FEDERAL AND TRIBAL INCENTIVES TO PRIVATE SECTOR BUSINESSES WILLING TO RELOCATE ONTO AN INDIAN RESERVATION. THE INTENT BEHIND THIS LEGISLATION IS NOT ONLY TO STIMULATE BADLY NEEDED ECONOMIC ACTIVITY ON INDIAN LANDS BUT TO CREATE A PARTNERSHIP BETWEEN INDIAN TRIBES AND THE PRIVATE SECTOR THAT WILL HOPEFULLY LEAD TO LONG-TERM ECONOMIC DEVELOPMENT. I BELIEVE THERE ARE SOME THINGS THE PRIVATE SECTOR IS BETTER ABLE TO DO THAN THE FEDERAL GOVERNMENT. I BELIEVE THEY CAN GREATLY ASSIST IN THE DEVELOPMENT OF RESERVATION ECONOMIES. COMBINE FEDERAL AND TRIBAL INCENTIVES WITH THE DETERMINATION OF THE PRIVATE SECTOR, WHO DEPEND ON PROFITS AND NOT FEDERAL APPROPRIATIONS, AND I BELIEVE YOU HAVE A POWERFUL FORCE THAT CAN ASSIST A NUMBER OF TRIBES THROUGHOUT THE COUNTRY. I HARBOR NO ILLUSIONS. MY BILL IS NOT A PANACEA. FOR SOME TRIBES THE INDIAN ECONOMIC DEVELOPMENT ACT WILL NOT WORK. IF SO, THEN LET'S FIND OTHER WAYS TO STIMULATE THEIR ECONOMIES.

WHAT I CANNOT ACCEPT IS THAT AS A NATION WE HAVE BECOME MORE CONCERNED ABOUT UNEMPLOYMENT IN THIRD WORLD COUNTRIES THAN WE HAVE ABOUT THE 30 - 90 PERCENT UNEMPLOYMENT ON INDIAN RESERVATIONS. WE HAVE BECOME ENAMORED WITH THE ROMANTIC IMAGE OF THE AMERICAN INDIAN; THEIR PROBLEMS HAVE BECOME INVISIBLE.

THE ECONOMIC OBSTACLES ON RESERVATIONS ARE ENORMOUS. MANY RESERVATIONS ARE REMOTE AND THEIR PHYSICAL INFRASTRUCTURES ARE UNDERDEVELOPED OR NONEXISTANT. JOB TRAINING CENTERS ARE DISTANT, INTERNAL CAPITAL IS LACKING AND EXTERNAL CAPITAL IS EXTREMELY DIFFICULT, IF NOT IMPOSSIBLE, TO OBTAIN.

PREVIOUS ATTEMPTS TO STIMULATE THE DEVELOPMENT OF RESERVATION ECONOMIES HAVE INVARIABLY INVOLVED FEDERAL AGENCIES PROVIDING GRANTS, SUBSIDIZED LOANS, LOAN GUARANTEES, AND INTEREST SUBSIDIES. THERE HAVE BEEN SOME SUCCESS STORIES, BUT MORE OFTEN

THAN NOT, THE ABOVE PROGRAMS HAVE FALLEN SHORT AS A RESULT OF DEFICIENCIES IN ADMINISTRATION, LACK OF TECHNICAL ASSISTANCE, LACK OF PROJECT REVIEW AND MONITORING, AND DECREASES IN PROGRAM FUNDING.

S. 788 TAKES A DIFFERENT APPROACH BY INVOLVING THE PRIVATE SECTOR IN RESERVATION DEVELOPMENT. THE GOVERNMENT BECOMES A FACILITATOR TOGETHER WITH THE TRIBE IN BUILDING A CLIMATE THAT IS ATTRACTIVE TO INDUSTRY. THE FEDERAL INCENTIVES ARE NECESSARY IN THIS PROCESS IN ORDER TO DEVELOP THE PHYSICAL INFRASTRUCTURE CAPABILITES NECESSARY TO LOCATE INDUSTRY ONTO MANY RESERVATIONS. I FULLY UNDERSTAND THE CONCERNS THAT AMENDMENTS TO THE TAX CODE OF 1986 WILL RAISE. GIVEN THE DESPERATE ECONOMIC CIRCUMSTANCES, HOWEVER, I BELIEVE THESE INCENTIVES MERIT SERIOUS CONSIDERATION.

I BELIEVE THE TAX REVENUES LOST UPFRONT WILL BE OFFSET BY REDUCTIONS IN WELFARE PAYMENTS AND INCREASED PAYMENTS OF PERSONAL INCOME TAXES BY PERSONS PREVIOUSLY UNEMPLOYED OR UNDEREMPLOYED. THERE ARE SOME WHO ARE CRITICAL OF ENTERPRISE ZONES ON THE BASIS THAT NO NEW JOBS ARE CREATED BUT RATHER THE JOBS ARE RELOCATED TO A DIFFERENT PART OF THE COUNTRY. WELL, THAT IS EXACTLY THE PURPOSE OF MY BILL: DIRECTING JOBS TO AREAS WITHIN OUR COUNTRY THAT HAS BEEN NEGLECTED FOR TOO LONG. THE CONGRESS DOES NOT HAVE THE LUXURY TO DEAL WITH INDIAN ECONOMIC DEVELOPMENT WHEN IT FINDS TIME. IT IS TIME FOR ACTION. I STAND READY TO WORK WITH MEMBERS OF THIS SUBCOMMITTEE IN DISCUSSING OTHER INCENTIVES THAT COULD BE OFFERED UNDER THIS BILL.

LIKEWISE, TRIBAL INCENTIVES WILL BE AN EQUALLY IMPORTANT PART OF THIS PROCESS. TRIBAL COMMITMENTS ARE NEEDED TO ASSURE THE PRIVATE SECTOR OF A STABLE BUSINESS ENVIRONMENT. ONE AREA OF CONCERN IN THE PAST HAS BEEN THE FEAR OF BUSINESS THAT THEY WILL NOT HAVE ADEQUATE RECOURSE IN CIVIL AND CONTRACT DISPUTES. S.788 ENCOURAGES TRIBES AND THE PRIVATE SECTOR TO DEVELOP A PLAN OF ACTION TO RESOLVE SUCH MATTERS.

SINCE INTRODUCING THE BILL, I HAVE RECEIVED NUMEROUS LETTERS OFFERING CONSTRUCTIVE COMMENTS ON THE BILL. I AM PLEASED TO RECEIVE THE ENCOURAGEMENT AND SUPPORT FROM INDIAN TRIBES AND INDIAN ORGANIZATIONS ACROSS THE NATION, SUCH AS THE NAVAJO NATION, THE NATIONAL CONGRESS OF AMERICAN INDIANS AND THE INTERTRIBAL COUNCIL OF ARIZONA. LIKEWISE MANY COMPANIES ARE

TAKING NOTICE OF THIS BILL--CP NATIONAL, THE MARMON GROUP, GENERAL DYNAMICS, AND ARIZONA PUBLIC SERVICE, TO NAME A FEW.

ONCE AGAIN, I APPRECIATE THE OPPORTUNITY TO APPEAR BEFORE THIS SUBCOMMITTEE. I LOOK FORWARD TO WORKING WITH THIS SUBCOMMITTEE TO DEVELOP A BILL THAT WILL PROVIDE ALL OUR INDIAN CITIZENS WITH THE SAME EQUAL ECONOMIC OPPORTUNITY WE OWE ALL OUR CITIZENS.

TESTIMONY OF
PETER MacDONALD

Thank you for the opportunity to provide you with my views on what I believe to be one of the most important pieces of Indian economic development legislation before Congress in recent memory -- the Indian Economic Development Act. As the proposed legislation encompasses several changes in the tax code, this Committee's focus on it is essential.

My name is Peter MacDonald and I am Chairman of our nation's largest Indian tribe -- The Navajo Nation. Our tribe's population is approaching 200,000 members; today, approximately one out of every five reservation-based Native Americans is a Navajo. Our Reservation spans Arizona, New Mexico and Utah. Some may find it hard to believe but the Navajo Reservation is larger than the states of Delaware, Massachusetts, Rhode Island, Vermont and New Hampshire combined.

I would like to present you with the demographics of the Reservation and the economic conditions which continue to plague the Navajo. Our people are young: The average age of a Navajo is 18, and fully one-half the population is under 21 years of age. Additionally, we are growing at a rate of three percent per year -- three times the national growth rate.

According to the 1980 Census, our per capita income was approximately $2,400 per year -- about 33 percent of that of the surrounding states. The official unemployment rate on our Reservation is 33 percent. This figure, however, does not take into account those who are discouraged and who have quit looking for work, nor those areas across our Reservation where joblessness ranges up to 60 percent and higher.

At the present time, 85 cents of every dollar earned by a Navajo is spent off the Reservation in the border towns and surrounding communities. This means that what Navajo disposable income dollars there are build the economies of border towns instead of contributing to the growth of a small business/service economy owned and operated by Navajos on our Reservation. In comparison, a dollar flowing through a typical U.S. community circulates five to ten times before going elsewhere.

To deal effectively with the circumstances I have just described to you, our goal is to create a thriving Reservation-based, job-generating private sector capable of creating 1,000 jobs per year. Job creation is not an end in itself. It is but a means toward an end. The alternative to job creation and new income into the hands of Navajos is continued dependence on day-to-day Federal assistance, and all the social ills bred by joblessness, empty days and no hope for the future. Moreover, without jobs we as a tribe face a future without hope. If our young people do not have an opportunity to apply their talents on the Reservation, what is to stop them from leaving? I also believe a healthy private sector will help us begin to solve some of the other pressing problems on the Reservation. The private sector will assist us in developing our infrastructure, improving the delivery of health care to tribal members and improving the quality of housing and education.

The legislation we are discussing today will be a powerful catalyst for attracting the private sector to Indian reservations. The legislation should be titled, "The Indian Competitiveness Act of 1987". Senator McCain is to be congratulated for his work on this bill. He has had the foresight since 1984, to introduce this legislation, in recognition that Tribal Governments require special assistance if they are to be able to compete on a more level playing field with states and foreign countries for private investment and jobs. There are those who will ask why tribes alone deserve such legislation to become competitive. Others question whether it is appropriate to open up the tax code after last year's tax reform. Others will question the bill's revenue neutrality.

Let me respond to these concerns. As to the equity of treating tribes specially, the Navajo Nation's unemployment rate is five times the current unemployment rate in the U.S. Our people have not had an opportunity to pursue the American Dream. To achieve our goals of private sector development, Federal tax incentives must be offered to companies willing to locate on the reservation. The reason for this is simple. At this stage in our development, we cannot yet offer the amenities to the private sector that corporations take for granted when negotiating with states. I am speaking of such requisites as a developed infrastructure, adequate housing and health care and a skilled and educated workforce. When a business calculates its investment decisions, all of these elements are figured into the equation. The tax incentives included in the Indian Economic Development Act will make the Reservation more competitive as a business site location, by offseting some of the disincentives that businesses face when considering investing on Indian lands, versus making similar investments in other states or overseas. This legislation will allow us to compete on a more level playing field, for industry and jobs and economic opportunity.

As to the revenue impact of this legislation, it is clear to me that such a powerful stimulus to employment will save our Federal Trustee many more dollars in direct assistance than it will cost in foregone tax revenues. As the result of the many treaties and executive orders signed over the past 100 years, the Federal Government is responsible for the health, education and welfare of the Navajo people and all Native Americans. Due to the current economic situation across Indian country, the Federal Government spends over $3 billion per year, fulfilling its trust responsibilities to Indian people. As we create jobs, we will lessen direct Indian dependence on such expenditures. Clearly, people will have greater disposable income as a result of these jobs and they will not need to depend on the Federal Government for subsistence. Expenditures and revenues must both be considered to accurately determine the impact of this legislation on the Federal budget.

I would like now to discuss some of the specifics of the legislation and propose some additional language to improve upon it. Let me first say that those who wrote this legislation provided a balanced approach between tribal requirements and federal incentives. It is wise to require specific actions by a tribal government before designation as an enterprise zone can occur. Tribal governments have got to take the initiative to make reservations more attractive to business. Let me say that the Navajo Tribal Government has implemented far-reaching measures to make our reservation competitive as a business site location. This is our responsibility and the actions we have taken show that the Navajo Nation Means Business!

Section 101(d) of the legislation requires "a reduction of tax rates" ... within the designated enterprise zone. The Navajo Tax Commission has fashioned a tax incentive package to be presented to our Tribal Council for approval which will reward companies for hiring Navajos. A credit against the tribal business activity tax will be granted to a company in the amount of 1 percent per Navajo employee during the first year of employment and will decrease by 2/10 of one percent per year until it phases out after five years. The credit will offset a corporation's tribal business activity tax and will be in effect for the employment of 100 Navajos. Earned tax credits can be carried over by a company for a period of 5 additional years.

This same section of the legislation requires tribal "actions to reduce, remove, simplify, or streamline governmental

requirements applying within the Indian Enterprise Zone."
The Tribal Council has unanimously passed its own legislation streamlining our business-site leasing process. The number of steps required to acquire a business lease has been reduced by more than half. Additionally, the maximum terms of leases have been extended from 25 to 99 years, and under the revisions, the improvements made to the site will all belong to the corporation.

The legislation also will require a tribe to focus on job training, increased efficiency in the delivery of services within a zone and the removal of the tribal government from business functions -- all of which we applaud. In the area of job training, the Navajo Division of Labor has excelled in utilizing its funding under the Job Training Partnership Act (JTPA). Our placement rates and hourly salaries compare favorably with those of the surrounding states. The Navajo Division of Labor can use its JTPA funds to train Navajos for the specific needs of modern industry.

I believe that the most important direction we as a tribal government can move in is to separate our governmental functions from the day-to-day management of business. I feel very strongly that the government of the Navajo Nation should regulate business, and not be involved in running business. We need to let the private sector manage its own affairs. I strongly believe in separating our governmental functions from business practices. Until we remove the Tribal government from the functions of business, free enterprise will be more of a dream than a reality on the Reservation. As you can see, we are taking the requirements in this legislation very seriously. We have moved forward on nearly every front.

Our Tribal government has gone even further than I could have hoped when I took office nearly eleven months ago. We have also capitalized a business and industrial development fund with $30 million of Tribal resources to meet the financing needs of the private sector. If business requires a building, we will help them build it; if business requires a road we will help them fund it. I believe all of these measures prove that the Navajo people want to move forward.

The federal incentives included in this measure are stimulative. Federal tax credits awarded for the hiring of disadvantaged workers will allow a company to reduce its federal tax obligations by employing Navajos. The investment tax credits in the bill for zone personal property, new zone construction property and zone infrastructure development should help to facilitate capital investment in enterprise zones. The 20 percent credit for infrastructure investment would help us to develop our infrastructure. As with most developing nations, infrastructure development is a great need. Exclusion from capital gains would also help to generate additional investment capital for entities within the zone and greatly assist in capital formation.

A vitally important provision of the bill, -- Section 231, provides Tribal governments the authority to issue industrial development bonds. As a matter of need and equity, tribal governments require such treatment. Since 1982, tribes have been allowed to issue tax-exempt bonds for public purposes. Tribal governments must have the ability to finance economic development projects by issuing tax-exempt bonds. (Parenthetically, rather than expand our ability to issue IDBs, the reconciliation bill passed by the House includes a provision that would limit our current authority to finance projects except for public purposes. How are we to repay such bond issuances without an income generating private sector? Although infrastructure development is essential, it does not generate new revenue to repay such bond issuances. I urge the Senate conferees to oppose this provision in the upcoming conference committee.)

To make this legislation even more stimulative, corporations willing to locate on the Reservation should be able to utilize the credits and other incentives generated by their Reservation activity. As you all know, a provision in last year's tax reform bill prohibits a company's tax rate from falling below 20 percent after utilization of available tax preferences. I strongly believe that companies willing to locate on the Reservation should be able to use the zone-originating tax credits they earn without limitation due to the TRA.

The Indian Economic Development Act is an innovative and far-reaching piece of federal legislation. Enterprise zones have been utilized by 32 states and over 700 jurisdictions as a means of revitalizing distressed areas. You should know that we have over 20 industrial prospects considering locating on our reservation. Several have told me that the tax incentives in this legislation would improve their bottomline and increase the possibility that they would locate at Navajo. This legislation is critical. If the Federal Government is truly serious in its proclamations about tribal self-sufficiency, it will give us the tools that this legislation provides.

My good friend, Robert A. Pritzker, who is President and Chief Executive Officer of the Chicago-based Marmon Group, a conglomerate of 70 companies with over $1 billion in annual revenues, wanted to join us today. However, prior commitments prohibited him from doing so. Bob wanted me to say a few words to you on his behalf today. The Marmon Group operates plants in countries around the world. Like other business leaders, he would rather invest in the U.S. economy and hire American workers. However, the tax holidays, labor rates and other incentives that his companies are offered by foreign countries compel any bottomline-minded businessmen to move offshore. Like any other businessman, he will locate where the potential return on his investment is greatest and where his risk is minimized. He has told me on several occasions that the incentives contained in the enterprise zone legislation would put the reservation on a more equal footing with foreign nations by increasing his potential rate of return and by minimizing the risk that he takes by investing on the Reservation. If we want to stop jobs from moving overseas and increase national competitiveness, what better place is there to start but on an Indian reservation?

Recently, we held an historic Economic Summit at Navajo. It was attended by five of your colleagues, four members of the House, two governors and ten business leaders. The purpose of the summit was to recommend policies that the Navajo Tribe, surrounding states and Federal Government could implement to support our growth. Two concrete messages emerged from that remarkable day of discussion. The first is that for Navajo to be successful it will require fundamental changes in tribal, state and federal policies. The Tribe and our surrounding states are moving forward. This legislation is a chance for the Federal Government to join us. Secondly, success is contingent on forging a unique tribal/state/federal and private sector partnership. We need our Trustee involved in this partnership.

I am optimistic about the future of Indian Economic Development in this country. This is the first time I have heard so many tribal and Congressional leaders speaking of the need to create jobs for Indian people. We now recognize that a partnership between the Tribe, the surrounding states, and Federal Government is essential to the development of a private sector and creation of employment opportunities. Jobs are the catalyst to moving our people from federal dependance to true self-sufficiency and economic independence. By allowing Indian tribes to compete on a more level playing field, this legislation could significantly facilitate private sector development on Indian lands. We urge the Federal Government to pass this legislation and to become our partner in growth.

Dr.Richard McHugh

I would like to thank the committee for giving me the opportunity to speak in favor of S.986, the Rural Enterprise Zone Act of 1987, a proposal to establish enterprise zones in America's rural areas.

As I'm sure you are all aware, the economies of this nation's rural areas have been severely battered in recent years. The farm economy has undergone a dramatic transition, the consequences of which I needn't remind you of here. What IS important to point out to you is the often neglected fact that the rural decline extends beyond the trouble in the farm economy. Nonfarm rural economies have also suffered disproportionately in recent years. The weakness in the manufacturing base of many of these areas has compounded the economic and social problems in rural America. While some parts of this country have grown at very rapid rates in the past few years, many others have continued to whither. Rural areas comprise a frighteningly large proportion of these troubled areas. The result has been a patchwork of economic profiles - some areas experiencing the pains of too rapid growth (wage increases, labor shortages, and other bottlenecks) while, at the same time, the economic map remains covered with areas which can best be described as being in a state of economic depression.

This bill proposes an approach to dealing with the problem of uneven growth through the establishment of rural enterprise zones - zones within which firms locating in the area would be given financial incentives for locating in that area. There are many arguments in support of efforts to divert growth into these areas - arguments which focus on the sociological aspects of the problem to the anecdotal tales of successes in state programs. I will not dwell on these aspects but will limit myself to a discussion of the potential effectiveness of these tax and financial incentives in addressing these problems. There are people here who are much more qualified to deal with the other issues.

This bill may be criticized on the grounds that it is a return to the old, pre-tax reform days, when social and economic problems were routinely addressed through the application of a dose of tax relief to influence economic choices. One of the widest criticisms of this approach has been that tax incentives, such as those proposed under this bill, have not been efective and that the tax incentives have not been "incentives" at all, but rather rewards to firms for doing what they would have done anyway. Secondly, even those who admit that the financial incentives have influenced the location of economic activity have argued that the growth induced in one area must necessarily have come at the expense of another area. That is, we have robbed Peter to pay Paul. Finally, many argue with these plans on the grounds that they are inherently inequitable. Let's take a closer look at each of these claims.

Much of the economics literature of the past twenty years is filled with empirical studies which have demonstrated the inability of these incentives to provide anything more than marginal influence. We have been taught that these inducements are essentially giveaways. The preponderance of emprical work over these years has formed a backdrop of suspicion about all such attempts to induce changes in the economic landscape through the use of these incentives. The past professional academic work of this nature has eventually worked its way into the conventional wisdom. However, in the past few years, there have been a growing number of studies which have shown that these incetnives have been important. This challenge to the conventional wisdom is attributable to a number of factors. First of all, the statistical sophistication of these studies of taxation's influence has progressed. Without going into details, I can assure you that with every refinement in the mechanisms of measurement and technique, these studies increasingly show that financial incentives are important, and have always been important.

Recent work also shows one additional, and very important fact. These studies also show that these incentives have become more effective in recent years. What may have been a marginal factor in years past is now found to be more powerful.

Is the growing importance of these incetnives a surprise? Is there any reason to think that the world is so much different in the 1980's that previously unimportant factors are now found to be significant? Or are the new findings as much a result of statistical flukes or sloppy empiricism as the earlier work which had shown these incentives to be useless.

There are a number of reasons to belive that the world is, in fact, a different place. In the 1960's and 1970's, slow growth was not an issue. However, in the past fifteen years, the United States' economy, and its industrial sector in particular, has been buffeted with slow growth in productivity and intense foreign competition. Rather than attempting to allocate the spoils of economic growth, this nation has had to learn to deal with retrenchment. The decisions have become tougher, and the decision makers have begun to more carefully scrutinize the bottom line in their decision-making process, such as in the decision where to locate. In the parlance of the economist, the demand side has become more price elastic. The incentives offered by communities and governments have become more important.

At the same time, the decline in the nation's industrial base has undercut the tax and economic base of many communities and governments. These governments have now come to appreciate the importance of a strong economic base and, in many cases, have begun to aggressively lure industry into their areas. The combination of the increased sensitivity of companies to financial incentives, and the increased sensitivity of governmments to the importance of economic growth to would lead us to suspect what we are now finding to be the case. That is, financial and tax incentives can work far better now than they had in the past. Another criticism of these plans has been that these incentives merely reallocate growth. What is given to one community is, necessarily taken from another. This, is probably an accurate, albeit stark and oversimplified statement of what we might expect to happen. But, is this bad?

Just last week I participated in two separate symposia. The first session dealt with the problems currently experienced in the Northeast as a result of their extraordinary growth: the problem of labor shortages. These industries cannot find workers and are looking for public policy solutions to this "problem". Several days later I participated in a session in which we attempted to design strategies to deal with the incredibly high rates of unemployment in parts of Missouri. There is clearly a frightening imbalance in growth patterns. Having studied Economics for the past fifteen years I have a more than adequate appreciation for the workings of the market economy and its capacity to, in the long run, efficiently allocate its resources.

However, I have also come to appreciate the fact that the process can be inordinately lengthy and excellent opporunities can be lost in the interim.

Second, the portrayal of development agencies as "robbers" greatly oversimplifies the process. Many studies have illustrated that the role if plant relocation on relative growth rates is small. The bulk of the observed growth differential results, not from firm movement, but from plant expansions and plant closures. The Missouri experience has shown that, in many cases, the decision has been one in which a firm has been faced with the decision of closing one or another of its plants. The enterprise zone legislation has been a factor in the decision which plant to close. In these cases, someone was bound to be the loser anyway. The government has simply made the decision to support one community over another.

Finally, policies to redirect growth can be justified on the grounds of equity. As indicated earlier, the role of government in attracting industry has grown by leaps and bounds. The job of attracting industry is itself one of the most rapidly growing of industries. The unfortunate consequence is that the less well-equipped and less resource endowed areas will suffer disproportionately because of the heightened competition. One of the reasons that the Missouri experience has been so favorable is that the State has shared in the risk. Without the capacity to gamble and bear the potential burden, many of these communities would have no choice but to simply roll over dead. In short, the government does have a duty to, and a role in, allocating growth or influence the patterns of growth.

Finally, why should rural areas in particular be targeted? When a company shuts down in a rural area, it is a disporpotionately large loss to the smaller communities. The choice often is not "Where to look for a job next" but rather "Should I abondon the look for a job or abandon the town"?

Some might say that the failure of rural industry is a market signal that the town's economy is fundamentally weak and should be abandoned. However, the closing of a company is not always a signal that the fundamental's of the local economy are weak, but rather may be the result of industry-wide, or company specific problems. The viability of the community is not signalled by the viability of one or several firms. Some might then also say that, in an unfettered market, if a community is viable, then a firm will locate in that area. Surely this is true, but as I said earlier, most differentials in regional growth are not the result of plant movement, but of plant expansion and contraction and of plant closure. To again harken back to something I had mentioned earlier, when a new plant begins its search, they must be alerted to the existence of these sites, and it becomes to a large extent, a salesmanship game. Many of the small rural economies are not well-equipped because of frighteningly inadequate resources.

In sum, recent research in the area of tax policy and its impact has revealed an emergin consensus. These incentives have worked, and can be a powerful inducement to industries to move into, or to stay in the rural areas of this economy.

STATEMENT OF THOMAS F. MULVANEY

Mr. Chairman, subcommittee members, fellow panel members and guests, thank you for the opportunity to testify before you today on this important issue.

My name is Thomas F. Mulvaney. I am Vice President and General Counsel for CP National Corporation. CP National Corporation's Chairman and Chief Executive Officer, Ben W. Agee, is unable to address this most prestigious group because of prior committments. Ben sends his regards to all of you.

CP National Corporation is a diversified communications, energy and manufacturing enterprise with operations in 11 states within the United States of America. Through these operations, it expects to generate 1987 revenue of approximately $250 million.

CP National's operations are divided into three (3) basic segments:

Communications - CP National provides communications services, including local telephone service, to 65,000 customers in rural areas of California, Nevada, Oregon, Texas and to the Navajo Nation through Navajo Communications Company and NCC Systems.

Energy - CP National distributes natural gas and electricity to 90,000 customers in California, Nevada and Oregon via supplies generated or purchased from third parties.

Manufacturing - CP National has two manufacturing entities, Ocean Technology, Inc. (OTI) and Denro, Inc. OTI manufactures signal processing equipment, graphic display terminal and provides support services for shipboard and control functions. OTI's principal customer is the United States Navy. Denro, Inc. manufactures micro-processor-based, integrated voice switching systems for airports, air traffic control centers and military installations. These systems are currently used by the FAA, the military and foreign governments.

Now that you understand CP National's business segments, let us focus on the Navajo Nation and its economic development. CP National is firmly committed to the Navajo people. Through Navajo Communications Company, CP National furnishes telecommunications services to the Navajo Nation. It provides local telephone, CATV, two-way radio service, as well as more sophisticated voice and data services to communities and businesses within the Navajo Nation.

CP National believes first and foremost in the Navajo people. To show CP National's level of commitment to the Navajo Nation, -- its Chairman, Ben W. Agee, has agreed to serve as a member of the Navajo Nation Business Development Task Force. This is a group of business leaders who have committed to being surrogate recruiters. Mr. Agee is impressed with the Navajo Tribal Government's efforts to enhance the business environment on the Navajo Nation.

A sustained effort on the part of the Tribal Government to improve the business environment, coupled with passage of the Indian Economic Development Act of 1987 will provide the Navajo Nation Business Development Task Force and the Navajo Nation with the tools they need to attract and enhance new and existing businesses.

CP National offers two perspectives concerning Senate Bill 788. The first perspective emanates from its experience of conducting business and assisting in the creation of an infrastructure on the Navajo Nation conducive to commercial enterprises. The second perspective offers some generic perceptions relative to present and future commercial enterprises on the Navajo Nation and Senate Bill 788.

Navajo Communications Company

Since 1970, Navajo Communications Company (NCC) has supplied telephone service to the Nation. Today, approximately 10,000 Navajo people and businesses receive their service from NCC. Both Ben Agee and Roy Kirkorian, CP National's President and Chief Operating Officer, have firmly committed NCC to the task of supplying the telecommunications service necessary to promote the development of the Navajo Nation's commercial infrastructure.

Telecommunications development in any environment requires major capital investment. While CP National is committed to making these investments, its future investment on the Navajo Nation would be facilitated in several ways by passage of the Indian Economic Development Act of 1987.

One, the incentives offered within the Bill, including employment credits and investment credits, will attract other commercial enterprises to the Navajo Nation as well as assist in the expansion of existing business enterprises. Two, the expansion of the Nation's commercial base will stimulate/grow the local economy. This growth, as well as the provisions of this bill, will facilitate additional capital expenditures by NCC in order to keep its system and service on the cutting edge of telecommunications technology. Three, as a result of these capital improvements, the Navajo Nation's telecommunications infrastructure will continue to be enhanced.

As a company currently doing business on the Navajo Nation, CP National urges you to recommend passage of SB 788 to the full Senate Finance Committee.

Present Future Commercial Enterprise - Navajo Nation

What does a commercial enterprise (individual, partnership or corporation) consider prior to deciding whether it will make a personal investment of funds to establish or expand a business on the Navajo Nation?

Normally, a business entity will examine several geographic areas and compare/contrast the potential labor force, business environment and commercial infrastructure before arriving at a decision whether to locate or expand within a particular area. There is substantial competition to attract and retain business between various geographic areas within the United States of America.

If the Navajo Nation is to compare favorably and compete with state and local governments in terms of a favorable business environment and responsive commercial infrastructure, the Indian Economic Development Act of 1987 must be adopted.

The incentives contained in Senate Bill 788 and the Navajo Tribal Government's efforts will enhance the Navajo Nation's business environment and aide in providing the necessary infrastructure to allow the Navajo Nation to compare and compete favorably with non-reservation areas.

Beyond the Indian Economic Development Act of 1987, there is another legislative issue of interest to CP National. Although this subcommittee has no jurisdiction over the following matter, I beg its indulgence.

CP National is aware of federal programs that offer incentives and preferential procurement opportunities to socially and economically disadvantages businesses.

For example, the Small Business Administration (SBA) is allowed to grant contracts to firms owned by socially and economically disadvantaged individuals. The goal of SBA's program is to facilitate the success of minority enterprises. CP National supports both of these very worthwhile programs.

CP National also believes that non-minority owned companies should be provided incentives in conducting their business, if those companies can demonstrate their business activities directly benefit the economic circumstances of a specific group of Native Americans. The incentives and preferential procurement opportunities could be extended to non-minority owned enterprises which employ large percentages of Native Americans, are based and operate on Indian owned lands and which generate additional economic activity on or near Indian owned land. Emphasis would not be placed on ownership and/or control of the business but on the direct economic benefit the business provides the Native Americans. An extension of benefits to these businesses would assist in the creation of new employment opportunities as well as stimulate the local economies on Indian owned lands.

For example, CP National Construction Company currently employs one hundred percent (100%) Native Americans on the Navajo Nation. Ownership of that entity resides in CP National. Although a number of Native Americans depend on this enterprise for employment, it does not receive any preferential treatment. Surely it should gain some advantage over an enterprise in the same business which employs non-Native Americans.

NCC has an outstanding record of employing people from the Nation. Currently seventy-one percent (71%) of the management team are Native Americans, while eighty-seven percent (87%) of the total work force are members of the Navajo Nation. CP National and NCC expect these numbers to grow in the ensuing years. Recognition of this employment record would be welcomed.

Conclusion

CP National Corporation is most pleased to be a part of the record of the Indian Economic Development Act of 1987. CP National thanks you for the opportunity to present its views and strongly urges you to recommend passage of Senate Bill 788. Thank you.

TESTIMONY OF CHARLES PACE

Chairman Bentson, Members of the Committee, thank you for the opportunity to appear at this hearing on the Indian Economic Development Act of 1987 (Act). My name is Charles Pace. I am the Director of Economic Analysis[1/] for the Shoshone-Bannock Tribes (Tribes) of the Fort Hall Indian Reservation (Reservation) in Idaho[2/].

Marvin Osborne, Chairman of the Tribal Business Council, asked me to express the Tribes' deep appreciation to Members of the Committee for their review and careful consideration of this important, urgently needed legislation. The Tribes are encouraged that the Chairman and others in Congress are actively considering legislation that puts certain tools of fiscal policy to work to improve the quality of life on reservations and in adjacent areas.

The Tribes are deeply committed to economic development and strongly endorse the intent of the Act. Economic development is the centerpiece of the Tribes' strategy for reaching their overarching goals of self sufficiency and self-determination[3/]. Economic development means training, employment, and entrepreneurial opportunities for unemployed and under-employed tribal members and nonmembers residing on the Reservation. Moreover, consistent with any tribal course of action agreed to in designating an enterprise zone, economic activity can establish an economic base that provides a stable source of tribal tax revenue for funding tribal governmental services.

New training, employment, and entrepreneurial opportunities for Reservation residents combined with improved tribal governmental services will bring powerful forces to bear in our efforts to alleviate the serious and devastating problems of poverty[4/] and unemployment[5/] on the Reservation and in the surrounding area. Strong, stable reservation economies based on viable industries coupled with enhanced capabilities of tribal governments will, ultimately, impact for the better the livelihood of all the members--Indian and non-Indian alike--of reservation communities.

Strong, stable reservation economies combined with effective tribal governance will enable tribes to reverse the historic alienation of tribal members from the reservation community, from each other, and from their elected leaders. By establishing resilient reservation communities, tribal governments can halt the substantial erosion of traditional support systems provided by immediate and extended families. The creation of new employment, training and entrepreneurial opportunities will also replace the anger and despair--desperation that now reaches into virtually every corner of reservation life--with compassion, tolerance and hope.

Minor setbacks experienced by individuals in their daily affairs or in the communal life of Reservation residents will no longer be capable of posing insurmountable obstacles for tribal governments. Economic development, supported and encouraged by strong, effective tribal governments, will avoid the cascading failures in family, tribal governmental, social, and economic networks that lie at the heart of reservation communities. In the past, these cascading failures have derailed tribal attempts to achieve self-sufficiency and self-determination.

The urgent need for economic development on reservation and improved tribal governance is partially addressed by the Act.[6/] Two key provisions in the Act are particularly important. Specifically, the Tribes strongly endorse the creation of certain federal (and tribal) incentives to encourage economic development within Indian enterprise zones. In addition, we welcome the proposal to allow tribes to issue so-called private activity bonds.

The key role finance plays in promoting economic development is undeniable[7/]. Allowing and encouraging tribes to issue private activity bonds is an important step in the right direction by Congress. Tribal enterprises and individual Indian entrepreneurs must have ready access to financial markets on attractive terms if economic development is to be realized. Tax-exempt securities generally provide tribes with the least costly method of accessing financial resources.

There are a number of opportunities available for promoting economic development using tribally issued, tax-exempt securities. At the same time there are many obstacles to doing so. Very few Indian tribes, to date, have effectively utilized this capability to finance economic development projects. There are several reasons for the limited use of tribes' existing tax-exempt borrowing capabilities which Congress should consider in allowing tribes to issue private activity bonds.

For tribal leaders, the process of structuring, syndicating, and selling securities can be very confusing. Similarly, the process of governance on Indian reservations may appear to be very arcane to the uninformed investment banker. If, over time, tribal leaders and the financial community establish long lasting, mutually beneficial relationships, the prospect for financing economic development using tribal tax-exempt securities is indeed exciting.

Economies of scale encountered by tribes in attempting to participate in the financial markets may still provide a barrier to engaging in such activities. The up-front costs of retaining a top investment banking firm to structure and syndicate a debt issue and place securities on attractive terms for the tribes is prohibitive for small--less than, say, $10 million--issues. Congress, by allowing tribes to issue private activity bonds, will encourage tribes and investment bankers to make the initial commitment of time, money, and effort that is required for tribes to access financial markets.

Another serious problem in financing Indian economic development that will be mitigated by this Act is the present uncertainty over the tax-exempt status of tribal securities. Members of the Committee are no doubt aware of Congressman Gibbons' efforts in the House to severely--and unnecessarily--limit tribes' access to financial markets by unreasonably restricting the definition of "essential" tribal governmental functions[8/]. We mention the Congressman's misguided efforts here because his amendment has created such uncertainty that it is virtually impossible for tribes to issue tax-exempt securities for any purpose until this matter is resolved.

In any issue of tribal tax-exempt bonds it is absolutely essential that the tax-exempt status of the tribal securities be assured. Otherwise, interest earned by investors is subject to the full force of federal (and perhaps state and tribal) taxes on corporate and personal income. If there is even a remote possibility that tribal securities will not be tax-exempt, investors won't touch them. Investment bankers will be reluctant to devote much time and effort to Indian finance if the tax-exempt status of securities is open to question. As a result, tribes will not have access to low-cost funds for financing economic development projects. Absent access to financial markets, Indian economic development will never be realized.

Present statutes provide that income from holding tribal securities is not exempt from taxation if the securities are private activity bonds, i.e., if it is determined that bonds are used for a trade or business and the proceeds of the bond sale are used to secure repayment of the tribes' obligations. Subtitle D of the Act excludes application of restrictions on tribal tax-exempt issues to finance economic development projects using private activity bonds. This provision will allow tribes to issue a broader range of tax-exempt obligations than is now allowed. More important, by allowing tribes to issue securities for essential governmental functions as well as private activity bonds, Congress will allay investors' fears of earning taxable income in the form of interest payments on tribal securities. The resulting reduction in uncertainty will greatly facilitate financing of Indian economic development projects.

It is also appropriate that Congress create financial incentives for economic development in Indian country by providing federal tax credits for increased employment and employment of economically disadvantaged individuals, credits for investment, and exclusion from gross income of capital gains on property in Indian enterprise zones. Provisions for carry back and carry over credits for increased employment relative to a base period coupled with credits for employing economically disadvantaged individuals may provide powerful incentives for increased economic activity on Indian reservations. Similarly, credits for investments in tangible property and exclusion of capital gains enjoyed while actively conducting trade or business within an Indian enterprise zone promises to bring additional capital onto reservations in unprecedented amounts.

The relationship between tax incentives in particular and economic development is less understood than are linkages between financial deepening and economic development. There has been much disagreement among economists over the extent to which tax incentives are a determining factor in the startup and location decision of new business enterprises. Nevertheless, the Tribes, subject to certain qualifications, support the use of limited federal (and tribal) incentives as part of an overall strategy for encouraging economic development. For business enterprises operating within an Indian enterprise zone, certain programs and actions promulgated by the federal and tribal governments will be undertaken to reduce various burdens--tax and otherwise--borne by employers. We are especially enthusiastic about instituting procedures for conflict resolution within Indian enterprise zones so long as tribal sovereignty is left intact.

The Tribes do have some reservations with certain provisions in the Act, particularly the manner in which this legislation would be implemented. Specifically, we are concerned that the Act will give the Secretary of Interior too much discretion in selecting between those Indian enterprise zones which have been nominated by tribal governments. We understand that when the Indian enterprise zone concept was originally suggested, there was an upper limit on the number of zones that could receive Secretarial approval. This provision would have placed Indian tribes in direct competition with each other. While such quotas are no longer included in the legislation, there are provisions which could in effect set tribe against tribe in "bidding" for Secretarial approval.

The Act requires that tribal governments follow a "course of action" that may include reduction of tax rates, fees, or royalties applying within the zone, increased local services, streamlined governmental regulations, and provision for public involvement, and protection of non-tribal interests. In its present form, the Act allows the Secretary, in choosing nominated areas for designation, to give special preference to areas in which a tribal government has provided the "most effective and enforceable guarantees" that it will indeed follow the course of action. Our fear is that, in order to receive Secretarial approval, tribes may promise a course of action that is not in their best interests. For example, some tribes might promise to forego taxation altogether in an effort to obtain approval only to discover at a later date that they cannot fund tribal governmental services.

The potential for tribes to engage in a bidding war against each other can be eliminated by establishing specific criteria for the Secretary to use in designating enterprise zones. For example, to receive Secretarial approval, a zone might have to exhibit a certain proportion of households earning less than the poverty level. Similarly, the unemployment rate might have to exceed a certain level.

Admittedly, such provisions are already included in the Act. However, we believe that if a nominated area meets such criteria, approval by the Secretary should be forthcoming. The Secretary should be given flexibility and discretion only for those nominated areas that do not satisfy established criteria. The Secretary should not have discretion to pick and choose between nominated areas based on what governmental authority a tribe is willing to relinquish.

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[1] I have been working for the Tribes on a three stage federally-sponsored economic development program since 1984. Over the last three years I have directed projects designed to lay the foundation for enhancing the Tribes' governmental capabilities, encouraging the participation of Tribal members and others in the promulgation of Tribal policy, funding essential governmental services, establishing viable markets for Tribal enterprises, and assessing the impacts of local, regional, national and international developments on the Reservation economy.

[2]. The Shoshone-Bannock Tribes collectively comprise a single federally-recognized Indian tribe. See Swim v. Bergland, Civil No. 78-4021 (D. Idaho 1981), aff'd in part and reversed in part, 696 F.2d 712 (9th Cir. 1983). The Tribes are the successors-in-interest of Indian signatories to the Fort Bridger Treaty of July 3, 1968. 15 Stat. 673. That Treaty and other Executive Orders reserved the Fort Hall Indian Reservation in southeastern Idaho territory as a permanent tribal homeland. In addition, Article 4 of the treaty guaranteed the continuation of a broad range of tribal use rights on unoccupied lands outside the Reservation.

[3]. Tribal governments have no suitable alternative but to strive for self-sufficiency and self-determination. Continuing dependenace upon various loosely coordinated federal programs retards sustained progress toward long-term tribal goals and leaves tribes vulnerable to shifting national priorities. Economic dependency and the correlative problems of chronic unemployment and widespread poverty endanger the continuation of tribal language and culture and the continuation of tribes as sovereign governments. Perhaps most significant, economic dependency has tainted tribal members' views of the legitimacy of tribal government and altered--for the worse--members'concept of tribalism.

[4]. According to the 1980 Census, 66 percent of the households on the Reservation live above the poverty line and 34 percent live below it. Poverty clearly falls disproportionately upon the Indian portion of the Reservation. Of Indian households, in 1980, 56 percent live above the poverty line and 46 percent live below it. For non-Indians, 83 percent live above the poverty line and only 17 percent live below it.

[5]. 1980 Bureau of Census data indicate that a total of 497 persons residing on the Reservation age 16 and over experienced unemployment in 1979. The mean duration of unemployment for males was 20.52 weeks, for females 17.6 weeks. Indians accounted for about 64 percent of all unemployed males, 61 percent of all females, and 78 percent of all persons 16 years and over experiencing unemployment. In contrast, only 53 percent of the Reservation population is Indian.

[6]. Note, however, that the provisions in the Act fall far short of the recommendations provided by either the Presidential Commission or the Task Force on Indian Economic Development. See Presidential Commission on Indian Reservation Economies, Report and Recommendations to the President of the United States, (November 1984); Task Force on Indian Economic Development, Report of the Task Force on Indian Economic Development, Washington, D.C.: Department of Interior (July 1986).

[7]. Economists have identified a number of empirical links between extensions of financial markets and economic development in comparisions of advanced with lagging economies. Generally, financial debt rises relative to income when real economic activity accelerates and economists assign these linkages between the financial markets and the broader range of economic activity a critical role in a developmental context. For example, see early works by R. Goldsmith, Financial Structure and Development (New Haven: Yale University Press), 1969; J. Gurley and E.S. Shaw, "Financial Aspects of Economic Development, "American Economic Review, Volume XLV, Number 4 (September 1955), 515-538; "Financial Development and Economic Development," Economic Development and Cultural Change, Volume 15, Number 3 (April 1967); E.S. Shaw Financial Deepening in Economic Development (New York: Oxford University Press), 1973; and R. McKinnon, ed., Money and Finance in Economic Growth and Development (New York: M. Dekker), 1976.

[8]. It is our understanding that the Bureau of Indian Affairs and Treasury are engaged in a process which, hopefully, will clarify the notion of essential functions for tribal governments.

DENNIS ROEDEMEIER

The existance of programs to stimulate economic development are not new, as is the existance of economic distress. The problem is that these programs often confront or deal with the symptoms of economic distress. The major hurdle which communities must overcome is that excessive welfare programs, poor housing, vacant store fronts, poverty and economic destitution are only symptoms of a disease, they are not the disease. The disease, the cancer which ravages a community, is the lack of jobs. This one factor, the creation of jobs, is often the difference in the survival or extinction of many of our communities across America. If we accept this basic premise and if we choose to focus on job creation then how do we create these jobs?

The Enterprise Zone program we devised for Cuba was the catapult for our success. It was the vehicle which we needed to fight back against our demise. The following items are offered in light of what we as a community have discovered about the concept of Enterprise Zones. What works and what does not work!

1) An Enterprise Zone must be a marriage of state effort, county effort, and city effort. If a Zone is to be successful, all must give equally to their ability. For example, if the state provides job credits and tax incentives, then the county must provide tax abatements, and the city must provide tax abatements, utility rebates and land. The philosophy of contribution to such an effort can not, and should not, be interpreted to be a liberal approach or a conservative approach. The Cuba philosophy was more in keeping with the story of the "Widow's Mite" (Mark 12:42)

2) There should be a specific number of zones established. In order to receive a designation an area msut demonstrate eligibility and need due to poverty levels, unemployment levels, or the lack of full-time employment. The establishment of a fixed number of zones will stop the future proliferation of zones which would lead to a watering down of the program. The other problem which open-end zone designation creates for government is that it will become an unending political issue in deference to an economic policy.

3) Enterprise Zones should be awarded to eligible areas on the basis of competition. In order for an eligible zone to win a designation they must present a written business plan stating such factors as how they will market their zone, what type and size of industry they are after, information on the quality and design of the infrastructure, and methods and sources of funding to be used. If a community cannot write out their plan I have found they cannot execute their plan.

4) In that there would be a limited number of zones, the Federal Zone Coordinator should reserve the right to de-authorize a zone for unacceptable performance. This process could be initiated in such a manner as to advise an area prior to de-authorization that their performance is below acceptable standards and that a new plan should be submitted, and steps should be taken to improve performance over a given amount of time.

5) Enterprise Zone benefits should be extended to companies which basically manufacture, process, distribute, or assemble. It is best to avoid extending benefits to the retail and commercial

enterprises in a zone area. Existing manufacturers have the wherewithal to expand to meet the criteria for zone benefits (i.e.: increased capital outlay and job creation) however retail and commercial operations are unable to meet these criteria, and yet remain competitive with a new store locating in the zone that is taking advantage of the Enterprise Zone benefits.

6) Each zone should have a Transfer of Technology program in place with a local university. It is a well known fact that America leads the way in technical research, however, our industries are suffering severely from the lack of exposure to these new processing approaches and manufacturing techniques. Cuba has linked each new company with a representative or professor from the University of Missouri - Rolla. In fact 8 out of 15 of our new industries have located in Cuba due to this program.

7) Each zone should have in place an adult education program which will bring the local citizens up to speed in the areas of mathematics, english, economics and finance. The City of Cuba established a program for 100 students of which 65 completed the course with passing grades. As stated earlier, an Enterprise Zone is a marriage of groups providing available resources, and industry must provide support in the area of education. Industry stands the most to gain from adult education and it should be their number one priority.

8) Those who direct the efforts of the Enterprise Zone on the local level must honor and report directly to a governmental entity such as a city council or county court. It is important that the local Enterprise Zone group report to an

agency which can provide direct support and resources in the area of equipment, machinery, materials and labor.

9) Before a zone is designated, the local banks within that zone must commit their institutions to the complete support of the economic development of that area. The banks must agree to utilize and promote the financing programs available for project credit enhancement from the federal, state, and local funds available. The banks must agree to sponsor and nurture new business start-ups and lend a watchful eye to their development and growth. Finally, the banks must put their interest rates where their public statements indicate they will be.

10) One of the hottest issues in today's economic development circles is the question of community and state give-aways in order to increase employment. Cuba literally gave away all they had. The list below indicates some of the incentives provided by the City of Cuba for new industry:

    1) Free land in the Industrial Park
    2) Abatement of real estate tax for 10 years.
    3) Utility rebate of 30% in year one,
       20% in year two,
       10% in year three,
       5% in years four and five
    4) County abatement of taxes for 10 years
       50% county abatement for 15 years thereafter
    5) Free utility hook-up
    6) Free base gravel for roads and parking lots.

Some have said the Cuba plan is overly agressive and, in the beginning, others were less kind with their opinion. However, let me give a few recent numbers from our records:

1) Food stamps in our county have been reduced from $85,000 per month to $55,000 per month. A savings of $360,000 per year to our tax payers.
2) Unemployment has dropped from a high of 14% to a low of 5%.
3) Sales tax revenues have increased by 33%
4) City revenues have increased over 50%.
5) 15 industries have moved into the Cuba Enterprise Zone within the last 2½ years, creating 850 direct manufacturing jobs and the empty story fronts of a few years ago are now filled.

A midwest governor I feel summed up the Cuba effort best when he said "they seemed to have put to work the philosophy that the more you give, the more you receive." How strange that the Christian Philosophy works so well in current Economic Theory.

STATEMENT OF SENATOR ALAN K. SIMPSON

Simpson

Mr. Chairman, I commend you for holding this hearing on S. 788 -- a very important piece of legislation for both Indians and non-Indians alike.

When I joined on as an original cosponsor in March of this year, it was because I believed then, as I believe now, that this would be a very useful tool for development of Indian economies in my state and throughout the country.

I first considered this type of legislation after a meeting with both Indian and non-Indian constituents of Wyoming. The Shoshone and Arapahoe Indian tribes have their own reservation -- the Wind River Indian Reservation -- located centrally in the state of Wyoming. During this meeting, I discussed with these folks their desire and need for a major meat packing facility in the state of Wyoming. It was obvious to those in attendance that such a facility could be advantageous not only to the local Indian economy and that of the neighboring town of Riverton, but throughout the state of Wyoming. It was quite evident that legislation establishing Indian enterprise zones would certainly assist in the efforts to establish that kind of facility.

Particularly important within this legislation is the attempt to reduce the barriers to Indian and non-Indian cooperation in economic development efforts which will benefit both. Those portions of the bill which reduce the burdens borne by employers and employees within the zones -- with respect to tribal government requirements -- are as important as the tax credits and exemptions provided to investors who are within the economic zones.

This bill will stimulate cooperation between Indian and non-Indian business communities. The result, I believe, will be an increase in economic opportunity on the reservation. Also of great importance will be the increased cooperation between Indians and non-Indians. Such cooperation on a business level cannot help but lead to cooperation between tribal and non-Indian government authorities as well and foster general good will among residents of both the reservation and neighboring communities.

Mr. Chairman, I do appreciate this opportunity to offer these remarks. I intend to review the full testimony provided here today very carefully. I stand ready to assist this Committee as you go about your work with this legislation. Once the bill is moved out of committee for consideration by the full body, I am confident that its merits will become self-evident and that we will bring this effort to a good result for the benefit of both Indians and non-Indians alike.

STATEMENT OF
C. EUGENE STEUERLE
DEPUTY ASSISTANT SECRETARY
(TAX ANALYSIS)
DEPARTMENT OF THE TREASURY

Mr. Chairman and Members of the Subcommittee:

I appreciate this opportunity to appear before you today to present the views of the Treasury Department concerning S. 788, which would establish an Indian enterprise zone program, S. 983, which would establish a rural enterprise zone program, and S. 1781, which would increase the charitable contribution deduction allowable to persons who donate to certain organizations depreciated debt instruments issued by developing nations. I will discuss the enterprise zone bills first and then will discuss the proposal concerning the treatment of charitable contributions of debt of developing nations. I must note at the outset that time considerations have precluded the coordination of our testimony regarding S. 1781 with other interested executive branch agencies.

S. 788 and S. 983 -- ENTERPRISE ZONE PROPOSALS

The Administration has supported and continues to support experimental enterprise zone initiatives intended to relieve economic distress in inner cities, rural towns, and Indian reservations. The President's budgets as recently as fiscal year 1986 included such a program. Congress has never enacted proposed enterprise zone legislation.

The enterprise zone initiative offered by the Administration in the past was structured to create a free-market environment in depressed areas through the easing or removal of government burdens. Although Federal tax incentives were an important part of that proposed program, its success was to depend largely on contributions by State and local governments through improved services and through relief from local taxes, regulations, and other burdens that could inhibit economic activity in these designated areas. The proposed program also was to depend on the involvement of private organizations, including private-sector neighborhood organizations and perhaps some private firms providing traditional city services.

The Administration continues to support the enterprise zone concept as a constructive approach to assist structurally depressed local economies. However, a Federal enterprise zone program should be considered in the context of current budget constraints. Budget negotiations are underway between the Administration and the Congress in order to reduce the budget deficit. Enactment of tax incentives for enterprise zones would reduce revenues, and, thereby, would require enactment of other measures to increase revenues or reduce spending to achieve a given amount of deficit reduction. Any proposed tax incentives and spending programs must be balanced properly to promote the intended goals as efficiently as possible.

Moreover, the role of Federal tax incentives in any enterprise zone program should take into account the changes and compromises contained in the Tax Reform Act of 1986 (the 1986 Act). The 1986 Act significantly lowered marginal Federal income tax rates, removed many special incentives from the Federal tax code, and addressed concerns about the fairness of the tax system. In order to protect the economic gains from tax reform, the Administration is committed to support the compromises made in the negotiations leading to its passage.

Thus, the Administration believes that consideration of S. 788 and S. 983 should be deferred. Although we continue to support the enterprise zone concept, we believe that the current budget situation and the new tax reform law provide an opportunity to reassess the proper mix of tax incentives and other Federal programs intended to encourage business development in economically distressed areas most efficiently.

In the meantime, the Administration has requested budget authority of $5.3 billion in fiscal year 1988 for community and regional development, and has proposed legislation that would target this assistance toward the most needy communities. The Administration also supports the current enterprise zone programs of State and local governments. These programs improve services, provide relief from local taxes, regulations, and other burdens that inhibit economic activity in economically distressed areas, and involve private organizations in close working relations with local governments.

Next, I would like to discuss the tax issues raised in these two enterprise zone bills.

Current Law

Existing Federal tax incentives generally are not targeted to benefit specific geographic areas. Although the Federal tax law contains incentives that may encourage economic development in economically distressed areas, they are not limited to use with respect to such areas.

Among the existing general tax incentives that aid economically distressed areas is the targeted jobs tax credit. This credit, which provides an incentive to employers to hire economically disadvantaged workers, often is available to firms locating in economically distressed areas. An investment credit also is allowed for certain investment in low-income housing or the rehabilitation of certain structures. Another type of tax incentive permits the deferral of gain taxation upon certain transfers of low-income housing and certain exchanges of business or investment property for property of the same kind. As a final example of a general tax incentive benefiting economically distressed areas, State and local governments are permitted to issue a limited number of tax-exempt private activity bonds that provide low-cost financing for businesses to begin or expand their ventures.

Credit for Employers

Employers that hire individuals from certain target groups are allowed a tax credit based on first-year wages of eligible individuals beginning work before January 1, 1989. An eligible worker falls into one or more of the following categories: (1) a vocational rehabilitation referral, (2) an economically disadvantaged youth, (3) an economically disadvantaged Vietnam veteran, (4) a recipient of supplemental security income benefits, (5) a general assistance recipient, (6) a youth participating in a cooperative education program, (7) an economically disadvantaged ex-convict, (8) an eligible work incentive employee, (9) an involuntarily terminated CETA employee, and (10) a qualified summer youth employee. An individual must receive a certification from a designated local agency that he or she is a member of a target group.

The targeted job credit generally is equal to 40 percent of the first $6,000 in qualified first-year wages paid to each employee in the target groups. For economically disadvantaged summer youth employees the credit is 85 percent of the first $3,000 of qualified first-year wages A qualified individual's wages are eligible for the credit only if that individual is employed for at least 90 days (14 days for economically disadvantaged summer youth employees) or has completed at least

120 hours of service performed for the employer (20 hours for economically disadvantaged summer youth employees).

Investment Credits

An investment tax credit is provided for owners of residential rental property used for low-income housing that is placed in service before January 1, 1991. The credit is allowable annually, generally for a period of ten years. For qualifying low-income housing projects placed in service in 1987, a 9 percent credit applies to new construction and rehabilitation expenditures relating to the low-income sections of new buildings that are not Federally subsidized. In addition, a 4 percent credit is available with respect to the acquisition cost of the low-income sections of existing buildings and of new Federally subsidized projects. For buildings placed in service after 1987, the credit percentages will be adjusted to permit recovery in present value terms of 70 percent and 30 percent of cost, respectively, for the two categories of credit.

Currently there is also a two-tier investment tax credit for qualified rehabilitation expenditures with respect to certain property depreciated on a straight-line basis. The credit percentage is 20 percent for rehabilitations of certified historic structures. A 10 percent credit is provided for rehabilitations of certain old nonresidential buildings that are not certified historic structures.

Capital Gains

Net gains from dispositions of capital assets generally are included in income and taxed at the regular corporate or individual income tax rates. However, special rules apply to certain dispositions of low-income housing. Owners of qualifying low-income housing projects generally may defer the gain realized upon transfers of such property to tenants if the proceeds are reinvested in another qualified low-income project within a specified time period. In general, deferral of gain also is permitted if a taxpayer exchanges tangible personal property or real property held for productive use in a trade or business or for investment for property of a like kind.

Tax-exempt Financing

The interest on State and local bonds generally is exempt from Federal income tax if the bonds are used to finance governmental activities, such as the construction of roads, schools, and sewers. State and local governments can use tax-exempt bonds to finance the development of public infrastructure in economically-distressed areas and other areas. Additionally, State and local governments can issue tax-exempt bonds for certain private activities ("private activity bonds"), subject to a number of limitations.

Indian tribal governments generally are treated as States for purposes of determining whether interest on obligations issued by them is tax-exempt. To qualify an issue of an Indian tribal government as tax-exempt, however, substantially all of the proceeds must be used in the exercise of an "essential governmental function." Indian tribal governments cannot issue tax-exempt private activity bonds. Temporary income tax regulations define "essential governmental function" to include functions of a type that are eligible for funding under certain Indian assistance acts. The definition of "essential government function" is currently being reviewed by the Internal Revenue Service to ensure that the scope conforms to Congressional intent.

Small-issue private activity bonds. Small-issue bonds are tax-exempt bonds issued by State and local governments for use by certain private businesses. Small-issue bonds must be part of an issue not exceeding $1 million, the proceeds of which are used to finance land or depreciable property. The $1 million limitation is increased to $10 million if an election is made to take certain related capital expenditures into account.

Small-issue bonds are subject to the private activity bond volume limitation. For years after 1987, the annual volume limitation for each State will be equal to the greater of $50 per resident of the State or $150 million. In 1987 the annual limitation is the greater of $75 per resident or $250 million. Each State's volume limitation is allocated one-half to State issuers and one-half to local issuers within the State on the basis of relative populations unless the State adopts a statute providing a different allocation.

The small-issue exception expired generally for bonds issued after December 31, 1986. In the case of small-issue bonds for manufacturing facilities and land acquisitions by first-time farmers, the exception expires for bonds issued after December 31, 1989.

Qualified redevelopment bonds. The 1986 Act allows the issuance of tax-exempt private activity bonds for redevelopment of locally designated blighted areas. Bond proceeds must be used to acquire real property located in blighted areas subject to the power of eminent domain, to clear and prepare land for redevelopment, to rehabilitate real property owned or acquired by the local government, or to relocate residents of the acquired property. The designation of blighted areas is to be based on State statutory criteria which take into account the excessive presence of vacant land, abandoned or vacant buildings, substandard structures, vacancies, and delinquencies in payment real property taxes. Qualified redevelopment bonds are subject to the State private activity bond volume limitation, but are not subject to a sunset provision.

Mortgage revenue bonds. Mortgage revenue bonds provide low-interest rate mortgages to families purchasing primary residences. Ninety-five percent of the proceeds must be used to finance mortgage loans to first-time homebuyers, except for financing with respect to targeted areas. The income limits for homebuyers do not apply or are higher for purchasers in targeted areas.

Two types of areas are targeted. One is a qualified census tract, defined as a census tract in which 70 percent or more of the families have income which is no more than 80 percent of the statewide median family income. The second is an area of chronic economic distress, which must be designated by the State and approved by the Federal government as meeting four criteria relating to the condition of the housing stock, need of area residents for owner-financing, the potential of owner financing to improve housing conditions, and the existence of a housing assistance plan.

Description Of Proposed Tax Incentives

Indian Enterprise Zones (S. 788)

S. 788 would make it possible for designated Indian enterprise zones to benefit from a combination of enhanced local commitments to reduce governmental burdens and Federal tax incentives. The bill would provide: 1) two tax credits for employers increasing employment in Indian enterprise zone; 2) an investment credit for certain investments in Indian enterprise zone property; 3) an exclusion from gross income for certain Indian enterprise zone capital gains; and 4) exemptions from certain limitations on tax-exempt financing of property in an Indian enterprise zone.

Credits for Employers

This bill provides two separate payroll credits for employers doing business in Indian enterprise zones. These credits would be available only with respect to "qualified employees," i.e., those performing 50 percent or more of their services within an enterprise zone and providing services at least 90 percent of which are directly related to the zone business. The credits would phase out during the last four years of a zone, declining by 25 percent per year.

The sum of the payroll credits would be limited to the excess of the employer's regular tax liability over its tentative minimum tax for the taxable year. Excess credits generally could be carried back to the earliest of the preceding three years and then forward for fifteen years. The amount of these credits would reduce the employer's deduction for wages.

Credit for increased enterprise zone employment. Indian enterprise zone employers would qualify for a 10 percent general payroll credit for "qualified increased employment expenditures." This is the amount by which the payroll for qualified employees in any taxable year exceeds the payroll for the base period, which is generally the twelve-month period prior to zone designation. Wages qualifying for the credit generally would equal the amounts included in the FUTA wage base, with a per-employee cap equal to 250 percent of such base (currently $7,000). Thus, the current maximum credit for qualified increased employment expenditures would be 10 percent of each qualified employee's wages up to $17,500, or $1,750 per employee.

The credit would be available to all employers for the qualified workers they employed within the zones, regardless of how many workers they employed elsewhere or what business activities they engaged in outside of the zones. The credit would apply to wages paid by existing firms to net additional qualified workers, representing an increase in the firm's work force, subject to the annual maximum wage cap per worker. The credit also would apply, subject to the per-worker wage cap, to increased wages paid to existing workers and wages paid to replacement workers to the extent such amounts caused the employer's payroll to exceed total wages paid to all former workers. However, the credit generally would not apply to the existing payroll of an existing business within a zone at the time it was so designated, nor would it apply to a worker hired by such a firm to replace a former, pre-zone worker making the same wage.

Credit for employment of disadvantaged individuals. In addition to the general payroll credit, enterprise zone employers would be eligible for a special credit for wages paid to qualified disadvantaged employees. This credit would equal 50 percent of wages paid (without limit) to each disadvantaged worker during each of the first three years of employment, with the percentage declining by ten percentage points per year thereafter. At the end of seven years of employment, no credit would be available with respect to a disadvantaged worker. Any wages taken into account for purposes of determining the economically disadvantaged credit would not be taken into account for purposes of computing the general payroll credit.

This credit would be targeted to aid low-income and hard-to-employ individuals. A qualified economically disadvantaged individual is defined as a tribal member certified either as meeting certain standards of economic disadvantage or as an eligible work incentive employee or general assistance recipient as defined for purposes of certification under the targeted jobs tax credit.

The special credit would be available to all employers for the disadvantaged workers they employed within the zones, regardless of the number of workers or amount of business conducted elsewhere. Additionally, the credit would apply only to disadvantaged workers hired after designation of the zone. These workers would not have to represent net additional workers or an increase in their employer's work force. Therefore, while the credit would not apply to the past payroll of an existing business in a zone, it would apply, for example, to the replacement with disadvantaged workers of workers lost through attrition.

The credit, with certain exceptions, generally would be recaptured if an individual was dismissed or fired within nine months after being hired.

Investment Tax Credit for Enterprise Zone Property

The bill would provide an investment tax credit equal to 5 percent of the expenditures for zone personal property, 10 percent of the expenditures for new zone construction property, and 20 percent of the expenditures for zone infrastructure investment.

Both zone personal property and new zone construction property are defined to include only property used by the taxpayer predominantly in the active conduct of a trade or business within an Indian enterprise zone. Ownership of rental residential, commercial, or industrial real estate within the zone would constitute the active conduct of a trade or business for this purpose. Zone personal property is tangible depreciable property other than nonresidential real property, residential rental property, and real property with a class life of over 12.5 years. New zone construction property generally is real property that is not zone personal property and, while the zone designation is in effect, is either newly constructed by the taxpayer in a zone or is located in a zone and acquired by the taxpayer as the original user.

Zone infrastructure investment qualifying for the 20 percent credit is defined as zone personal property or new zone construction property that benefits the tribal infrastructure and is available to the general public. Certain property outside the zone that relates to the zone infrastructure, such as roads, power lines, water systems, railroad spurs, and communication facilities, is included in this category.

This credit would be included in the business credit under section 38 of the Code. Thus, it would be limited in a given year to the lesser of (1) $25,000 plus 75 percent of the employer's regular tax liability in excess of $25,000, and (2) the excess of the employer's regular tax liability over its tentative minimum tax for the taxable year. Excess credits generally could be carried back to the earliest of the preceding three years and then forward for fifteen years. The basis in new zone construction property would be reduced by the amount of the new credit.

Upon an early taxable disposition of credit property or early termination of its status as qualifying property, there would be a proportionate recapture of the credit. The portion of the credit attributable to the part of the recovery period during which the taxpayer failed to hold the qualifying property would be included in income in the year of disposition or termination.

Capital Gain Exclusion

The bill would exclude from income a portion of the gain from sales or exchanges of specified capital assets held for more than six months. The exclusion would apply to gain with respect to tangible personal property used predominantly in an Indian enterprise zone in the active conduct of a trade or business within the zone and real property located in the zone and so used. Ownership of most rental real estate located within the zone would constitute the active conduct of a trade or business for purposes of the gain exclusion.

The exclusion also would apply to gain from sales and exchanges of interests in certain entities that for the three years preceding disposition had been actively engaged in a trade or business within a zone. Qualifying entities are identified as those with 80 percent or more of gross receipts attributable to the active conduct of a trade or business within a zone and substantially all tangible assets located within a zone. However, the exclusion would not encompass the portion of the gain attributable to (1) property contributed to the entity within the twelve months preceding disposition, (2) any interest of the entity in a business not meeting the active business, gross receipts, and asset location tests, or (3) intangible property not attributable to the active conduct of a trade or business within a Indian enterprise zone.

The exempt portion of the gain would be limited to the amount allocable to the periods that the property was qualifying property.

Exemption from Certain Tax-exempt Financing Limitations

The bill would permit Indian tribes to issue tax-exempt private activity bonds. The bill also would exempt Indian enterprise zone property from limitations on accelerated cost recovery deductions with respect to property financed with tax-exempt bonds. Finally, the bill would delete the December 31, 1986 sunset date for small-issue bonds substantially all the proceeds of which are used to finance facilities within an Indian enterprise zone.

Rural Enterprise Zones (S. 983)

S. 983 would aid designated rural areas by means of reduced Federal and local governmental burdens and increased Federal tax incentives. The bill would provide: 1) an employment credit related to increased employment in a rural enterprise zone; 2) deferral of gain on the sale or exchange of certain rural enterprise zone property; and 3) exemption from certain limitations on tax-exempt financing of property in a rural enterprise zone.

Credit for Employers

This bill would provide a payroll credit for employers doing business in rural enterprise zones. The credit would be available only with respect to "qualified employees," i.e., those performing 50 percent or more of their services within an enterprise zone and providing services at least 90 percent of which are directly related to the zone business.

Rural enterprise zone employers would qualify for a 10 percent general payroll credit for "qualified increased employment expenditures." This is the amount by which the payroll for qualified employees in any taxable year exceeds the inflation-adjusted payroll for the base period, which is generally the twelve-month period prior to zone designation. Wages qualifying for the credit generally would equal the salary amounts included in the FUTA wage base, limited to "the lower [sic] living standard for a family of four as determined by the Bureau of Labor Statistics".

The credit would be available to all employers for the qualified workers they employed within the zones, regardless of how many workers they employed elsewhere or what business activities they engaged in outside of the zones. The credit would apply to wages paid by existing firms to net additional qualified workers, representing an increase in the firm's work force, subject to the annual maximum wage cap per worker. The credit also would apply, subject to the per-worker cap, to increased wages paid to existing workers and wages paid to replacement workers to the extent such amounts caused the employer's payroll to exceed total wages paid to all former workers. However, the credit generally would not apply to the existing payroll of an existing business within a zone at the time it was so designated, nor would it apply to a worker hired by such a firm to replace a former, pre-zone worker making the same wage.

The payroll credit would be included in the business credit under section 38 of the Code. Thus, it would be limited to the lesser of (1) $25,000, plus 75 percent of the employer's regular tax liability in excess of $25,000, and (2) the excess of the employer's regular tax liability over its tentative minimum tax for the taxable year. Excess credits generally could be carried back to the earliest of the preceding three years and then forward for fifteen years.

Deferral of Capital Gain

The bill would defer taxation on the gain attributable to a sale or exchange of certain tangible enterprise zone property in the case of reinvestment of the proceeds in rural enterprise zone property within one year. Tangible personal property that is acquired and placed in service in a rural enterprise zone during the period the designation is in effect and that is used predominantly in a rural enterprise zone in the active conduct of a trade or business within the zone would qualify as property eligible for gain deferral. Similarly, the gain on real property located in the zone would be eligible for deferral treatment if the real estate was acquired while the zone designation was in effect and used predominately in the active conduct of a trade or business. The characterization of property as rural enterprise zone property for purposes of deferral would not be terminated by reason of expiration or revocation of the zone designation.

A portion of the gain realized [it is not statutorily specified what portion, an amount equal to the boot or an amount determined by subtracting a pro rata portion of the basis] would be recognized in the event that proceeds on disposition exceeded the cost of the replacement enterprise zone property. In addition, recapture gain with respect to depreciable property generally would be taxable upon disposition of the rural enterprise zone property. Any gain deferred on the sale or exchange would be preserved by means of a downward adjustment to the basis of the replacement property.

Exemption from Certain Tax-exempt Financing Limitations

The bill would exempt rural enterprise zone property from limitations on accelerated cost recovery deductions for property financed by tax-exempt bonds. The bill also would exempt tax-exempt bonds from the $1 million and $10 million limitations on qualified small-issue bonds, if such bonds were part of an issue 95 percent or more of the proceeds of which were used to finance facilities within a rural enterprise zone. The $40 million aggregate limit on the issuance of small-issue bonds applicable to each taxpayer would be applied by taking into account only small-issue financing in such zones. Finally, for any calendar year, any State with one or more rural enterprise zones would be required to set aside 5 percent of the State volume cap for private activity bonds for use only in such zones in such State.

Discussion

New Considerations Raised by Tax Reform

The revenue cost and structure of Federal tax incentives included in a proposed enterprise zone program must be reevaluated in the light of the impressive reforms enacted in the Tax Reform Act of 1986. The discussion that follows focuses on general concerns that would apply to any new enterprise zone proposal, such as the proposals contained in S. 788 and S. 983.

Revenue and incentive effects. The Administration's prior enterprise zone proposal, which contained provisions which are similar to those proposed in the bills, was estimated to cost $1.5 billion for the first three years. The Administration's program was proposed prior to the enactment of the Tax Reform Act of 1986. Certain changes enacted under the 1986 Act would increase the revenue cost of certain tax incentives contained in the Administration's prior proposal and often included in new enterprise zone proposals. First, a capital gains exclusion would be more costly, because the 1986 Act repealed both the partial exclusion of long-term capital gains from the income of individuals and the alternative preferential capital gains tax rate for corporations. Second, the revenue cost of the tax credit proposals is determined by taking into account the effect of reducing the wage and depreciation deductions of participating employers by the amount of the credits. Given the lower marginal tax rates under the 1986 Act, this offset to the revenue loss is less significant, making the net revenue cost greater.

The 1986 reforms would at the same time reduce the revenue cost and incentive value of proposed tax credits. Because companies earning enterprise zone tax credits would be more likely to pay the new minimum taxes, the revenue cost and incentive value associated with the tax credits would be reduced. Under the 1986 Act, tax liability is the greater of regular tax liability (after tax credits) or minimum tax liability. Incentive tax credits, such as employment and investment tax credits, cannot be used against minimum tax liability, although they can be carried back and carried forward to offset excess regular tax liability of other years.

Trade-off with other objectives. The objective of providing Federal incentives through the tax code may come into direct conflict with other objectives or compromises contained in the 1986 Act. For example, although capital gains are fully included in minimum taxable income under current law, an enterprise zone proposal could provide that capital gains earned in enterprise zones are exempt from the regular tax and also the minimum tax. The Indian enterprise zone proposal in S. 788 takes this approach. If the capital gains exclusion applies for minimum tax purposes as well as regular tax purposes, its incentive value is increased for many taxpayers. However, if the exclusion does not apply for minimum tax purposes, the incentive value of the exclusion is reduced, but the proposal achieves another important objective identified during tax reform and implemented in the new tougher minimum tax--ensuring that all taxpayers pay a minimum amount of Federal tax liability.

Economic distortions. The 1986 Act repealed the investment tax credit for equipment and machinery, and eliminated or reduced other tax incentives, in order to achieve lower marginal tax rates. These reforms increased the efficiency of our economy by reducing disparities in effective tax rates on income from different types of investment and reducing the interference of government in the private economy. Lower marginal tax rates reduced the cost of capital for all types of business property, including equipment, structures, land, inventory, and intangible capital. Low marginal tax rates are the most effective means of stimulating more investment, savings and work effort.

Economic distortions would be reintroduced by enacting investment tax credits for only certain types of human or physical capital as part of an enterprise zone program.

Federal vs. state direction of use of private activity bonds. The 1986 Act placed significant limitations on the use of tax-exempt private activity bonds. This was done to protect the value of tax-exempt bonds used for essential public purposes and to reduce the large and growing Federal revenue loss. An annual State volume limitation equal to the greater of $50 per resident or $150 million will be in effect in 1988 for private activity tax-exempt bonds, including small-issue bonds and qualified redevelopment bonds. The 1986 Act also included additional restrictions on the use of private activity bonds within the volume limitation.

The 1986 state volume limitation and use limitations addressed the principal Federal concerns about private activity bonds. Assuming such volume limitations significantly constrain the volume of tax-exempt private activity bonds that may be issued, it should be considered whether it is most appropriate for state and local government decisionmakers to determine which type of bonds are most needed in which communities. Thus, limitations on the use of small issue bonds to finance only manufacturing facilities (within the volume limit) might not be appropriate. This issue is relevant both if the total volume cap remains as present levels or if it is set at some higher level.

Conclusion

The Administration continues to support the enterprise zone concept as a constructive approach for dealing with problems of economically distressed areas. State and local governments already have shown the beneficial effects of removing burdens that inhibit economic activity in distressed areas. However, at the present time the realities of the Federal budget deficit must occupy a principal role in the shaping of any program to encourage efficient business development in economically distressed areas. In addition, any proposal should take into account the recent changes and compromises contained in the Tax Reform Act of 1986. For these reasons, consideration of these bills should be deferred.

S. 1781 -- CERTAIN CHARITABLE CONTRIBUTIONS OF DEVELOPING NATION DEBT

Present Law

Persons who make contributions to religious, charitable, and educational organizations may, subject to certain limitations, claim a deduction for the charitable contribution.1/ If the contribution is of property rather than money, the amount of the allowable charitable contribution deduction generally is equal to the fair market value of the property at the time of the contribution. Fair market value is the appropriate measure of the deduction since this is the amount that is available for charitable use by the organization. The fair market value of the property is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having a reasonable knowledge of the relevant facts.

Thus, under existing rules, a taxpayer who contributes property having a fair market value that is less than the taxpayer's basis cannot deduct the excess of basis over fair market value as a charitable contribution deduction. Nor may the taxpayer deduct the excess as a loss. In contrast, if the taxpayer sells or otherwise disposes of property for an amount less than its basis, the taxpayer generally is allowed a loss deduction in an amount equal to the difference between the property's bais and its fair market value. Consequently, in the case of property having a basis that exceeds its fair market value, the taxpayer obtains the full benefit of its basis in the property if the property is sold, but not if the property is contributed. A taxpayer who holds depreciated property and desires to make a charitable contribution can, however, obtain the full benefit of its basis in the property by selling the property at a loss and then donating the proceeds to a charitable organization.

The ability of taxpayers to obtain the full benefit of their basis in property by selling the property and contributing the proceeds is illustrated by Rev. Rul. 87-124, which was published by the Internal Revenue Service earlier this week. This ruling addresses the tax consequences of various transactions involving a foreign country and U.S. holders of debt instruments issued by the foreign country. In each of the transactions, the basis of the debt instruments in the hands of the holders exceeded the fair market value of the instruments. In the transaction relevant to this hearing, a U.S. commercial bank transferred a debt instrument of the foreign country to the central bank of the foreign country and, in accordance with a prearranged plan, the central bank credited the account of a charitable organization organized in the United States with an amount of local currency. The charitable organization could use the local currency only in the foreign country for charitable purposes.

Under these facts, the ruling holds that the U.S. commercial bank is treated as if it had received the local currency from the central bank and then contributed the local currency to the charitable organization. Accordingly, the U.S. bank recognizes a deductible loss in an amount equal to the excess of its basis in the debt instrument over the fair market value of the local currency, and may claim a charitable contribution deduction in an amount equal to the fair market value of the local currency.

S. 1781

S. 1781 would amend section 170 of the Internal Revenue Code to provide that, in the case of a "qualified debt contribution," the amount of the otherwise allowable charitable contribution deduction will not be less than the donor's basis in the contributed debt instrument. A qualified debt contribution is defined as a contribution to a qualified charitable organization of a debt instrument evidencing a loan to a foreign state eligible for World Bank or International Development Association financing. The donor must receive a written statement that the debt instrument, or the proceeds from the debt instrument, will be used for an international conservation purpose.

An international conservation purpose is defined by S. 1781 to mean the expenditure of funds in or with respect to the foreign country that is the issuer (or is the residence of the issuer) of the qualified debt instrument for any of a broad range of conservation activities. Among the permissible conservation activities are the preservation of land areas for outdoor recreation, the protection of a natural habitat of fish, wildlife, plant, or similar ecosystems, the support of museum, park, conservation, and nature and conservation education personnel and programs, and the facilitation of cohabitation between inhabitants of a particular area and fish, wildlife, plant, or similar ecosystems. An international conservation purpose also includes research and experimentation in connection with the activities described in the preceding sentence, as well as international, national, and local governmental programs to accomplish such conservation purposes.

S. 1781 also would exempt donees from the reporting requirements contained in section 6050L of the Code. Section 6050L is intended to provide the Internal Revenue Service with information regarding possible overvaluations of contributed property. Since the donor's deduction with respect to a contribution that qualifies for deduction under the provisions of S. 1781 would be measured by the donor's basis, rather than the fair market value of the contributed property, the information required by section 6050L would not be useful in this situation.

Discussion

The Third World debt crisis that emerged five years ago posed potentially serious risks to debtor nations and the global economy. Among the measures the Treasury Department has encouraged to address this problem are debt-equity swaps to reduce debt service burdens and conversions of debt instruments to local currency for use by charitable organizations. The conversion of debt instruments into equity and other claims will not, by itself, solve the debt problem; such conversions probably cannot be used to retire more than a small portion of the $288 billion owed to banks worldwide ($85 billion to U.S. banks) by the fifteen most heavily indebted developing nations. The conversions can, however, provide important benefits to both creditors and debtors.

S. 1781 is intended to encourage the conversion of debt instruments issued by developing nations into funds that will be put to use in the debtor nation. In this respect, the bill is consistent with the Treasury Department's goals. S. 1781 would achieve this goal by encouraging the contribution of debt instruments to conservation organizations, and thus would also have the positive effect of encouraging conservation measures.

Notwithstanding our recognition of certain positive effects of S. 1781, our recent analysis of issues relating to the contribution of debt to charitable organizations has led us to conclude that the adoption of S. 1781 is not necessary to encourage the conversion of debt instruments into funds that will be put to use in the debtor nations. Moreover, we are concerned that S. 1781 will favor certain charitable organizations over others and, by improperly characterizing the deductions of the donor, produce possible tax distortions. For these reasons, we believe that the enactment of S. 1781 is unnecessary.

S. 1781 would address the seemingly disfavored treatment of contributions of depreciated property by allowing donors a deduction equal to their basis in the depreciated property. As illustrated by Rev. Rul. 87-124, however, the disfavored treatment is more apparent than real, since the donor is free to sell the property and contribute the proceeds. Only in situations in which the charitable organization intends to use the particular property owned by the donor, and transaction costs associated with a sale by the donor and subsequent purchase by the charitable organization are substantial, do the existing rules act as a significant, and arguably inappropriate, disincentive to make charitable contributions.

If the Subcommittee concludes that the treatment of contributions of depreciated property should be revised, we suggest that certain aspects of S. 1781 be reconsidered. First, while international conservation purposes are meritorious, there is no reason to favor a single type of charitable organization over other charitable, religious, and educational organizations. Second, by characterizing the entire amount of the deduction allowable to the donor as a charitable contribution deduction, the bill provides taxpayers with possible tax avoidance opportunities in any situation in which the treatment of a charitable contribution deduction and a loss deduction may differ. The opportunity would arise since the taxpayer would be able to choose either to contribute debt to a qualifying charitable organization or to dispose of the debt at a loss and contribute the proceeds to a charitable organization.

Neither of these concerns is raised by Rev. Rul. 87-124. The ruling, and the general tax principles on which it is based, do not single out a particular type of charitable activity for special treatment. Moreover, the deductions allowed by the ruling are consistent with the substance of the transaction. The excess of the taxpayer's basis in the debt over the fair market value of the debt is not, in fact, an amount contributed to the benefit of the charitable organization. Rather, this excess is a loss realized by the taxpayer and, if allowed, should be characterized as such.

* * *

This concludes my prepared remarks. I would be pleased to respond to questions.

1/ The limitations on the allowable charitable contribution deduction relate both to the types of organizations to which the contribution may be made and to the amount of the allowable deduction. Among the limitations that are relevant with respect to contributions of developing nation debt is the requirement that, if a corporation makes a charitable contribution for use outside the United States or a possession, the donee must be a corporation organized in or under the laws of the United States, a State, or a possession.

DEPARTMENT OF THE TREASURY
WASHINGTON

March 29, 1988

Dear Senator Chafee:

I am writing in response to several questions you raised following the Treasury Department's testimony last November before the Senate Finance Committee concerning the scope of Rev. Rul. 87-124. This ruling addresses a situation in which a U.S. commercial bank transferred a debt instrument of a foreign country to the central bank of the foreign country and, in accordance with a prearranged plan, the central bank credited the account of a U.S. charity with an amount of local currency. The U.S. charity could use the local currency only in the foreign country for charitable purposes. The ruling holds that, under these facts, the U.S. commercial bank is treated as receiving the local currency from the central bank in exchange for the debt obligation (resulting in a deductible loss) and then contributing the local currency to the U.S. charity (resulting in a charitable contribution deduction).

You have asked whether the holding of the ruling would be the same under three alternative fact patterns. Under the first alternative, a U.S. commercial bank would transfer to the central bank of the foreign country debt obligations not of the central bank, but of another government agency or a nongovernmental entity organized under the foreign country's laws. Under the second alternative, the central bank would transfer to the U.S. charity newly issued bonds for the debt obligations instead of local currency. Under the third alternative, the currency or bonds would be credited or issued to a charitable entity organized under the laws of the foreign country rather than to a U.S. charity.

Rev. Rul. 87-124 applies the principle that, when there are two paths available to a charitable donor, the tax consequences "turn on which path he chooses, and so long as there is substance to what he does, there is no requirement that he choose the more expensive way." *Palmer v. Commissioner*, 62 T.C. 684, 693 (1974); *see* Rev. Rul. 78-197, 1978-1 C.B. 83. The particular facts of Rev. Rul. 87-124 were intended to illustrate this principle and not to preclude application of the principle in other appropriate circumstances.

The holding of Rev. Rul. 87-124 reflected a determination that the form of the transaction chosen by the parties (i.e., disposition of the debt instrument by the U.S. bank followed by a contribution of the proceeds to the charity) had as much substance as a possible recharacterization of the transaction that would have produced less favorable tax consequences (i.e., charitable contribution of the loan by the U.S. bank followed by disposition of the loan by the charity). This analysis of the transaction does not depend upon the identity of the issuer of the debt instrument or the form of consideration received upon disposition of the debt instrument.

Thus, we do not regard an exchange of a debt obligation of an entity other than the central bank of the foreign country, as in the first alternative fact pattern, as inconsistent with the principle underlying Rev. Rul. 87-124. Similarly, we do not regard the issuance of bonds rather than local currency, as in the second alternative, as inconsistent with this principle. We note that the bonds would have to differ sufficiently from the debt obligations for the transaction to constitute an exchange in which gain or loss is recognized.

As to the third alternative, the Internal Revenue Code permits a charitable deduction only if the contribution is made "to or for the use" of charities created or organized in the United States. A U.S. charity may work in cooperation with an entity organized under the laws of the foreign country and may solicit contributions for grants to the foreign entity without jeopardizing the charitable deduction, provided that the U.S. charity has such control and discretion regarding contributions as to ensure that the contributions will be used to carry out the U.S. charity's charitable functions and purposes. See Rev. Rul. 63-252, 1963-2 C.B. 101; Rev. Rul. 66-79, 1966-1 C.B. 48; Rev. Rul. 75-65, 1975-1 C.B. 79. There is also authority indicating that, in some circumstances, it may be possible for funds to be credited to the account of a foreign charity if use of funds in that account is limited to a specific charitable purpose and the U.S. charity had exercised discretion in selecting that charitable purpose. See Brinley v. Commissioner, 782 F.2d 1326, 1335 (5th Cir. 1986).

The tax consequences of any transaction depend on the facts and circumstances of the particular transaction. Accordingly, in this letter we can do no more than describe the general principles that would apply to the different fact patterns about which you have inquired. The Internal Revenue Service has a private letter ruling procedure whereby it provides taxpayers with advanced guidance regarding the tax consequences of particular transactions. We are confident that the Service would entertain private ruling requests regarding the facts and circumstances of a particular debt/charity conversion. No rulings, however, are given on the factual issues such as the fair market value of particular property.

Please contact me if I can be of any further assistance.

Sincerely,

C. Eugene Steuerle
Deputy Assistant Secretary
(Tax Analysis)

The Honorable John H. Chafee
United States Senate
Washington, DC 20510-3901

DAILY TAX
CORRESPONDENCE

FULL TEXT: WILMER CUTLER ASKS TREASURY TO REVISE REV. RUL. 87-124

(Section 170 – Charitable Deduction)

February 22, 1988

Ellen Aprill, Esq.
Attorney Advisor
Office of Tax Legislative Counsel
U.S. Department of the Treasury
1064 Main Treasury Building
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Re: Rev. Rul. 87-124 – Crediting Local Currency to Foreign Organization

Dear Ellen:

This letter responds to your request for a submission concerning whether a donor would qualify for a charitable contribution deduction under Rev. Rul. 87-124 if the funds it contributed were credited to the account of a foreign organization for purposes of funding a program of a U.S. section 501(c)(3) organization. Rev. Rul. 87-124 holds that a donor is entitled to the deduction if, in connection with the donor's exchange of U.S. dollar denominated debt for currency of a foreign country ("local currency"), the local currency is credited to the account of a U.S. section 501(c)(3) organization for use for charitable purposes in the foreign country. The charitable purposes for which the local currency is used must satisfy the requirements of section 170, including requirements set forth in Rev. Rul. 63-252, 1963-2 C.B. 101, and Rev. Rul. 66-79, 1966-1 C.B. 48.

Rev. Rul. 63-252 establishes the principle that if a U.S. section 501(c)(3) organization accepts contributions earmarked for the unrestricted use of a foreign organization, the contributions will not be deductible under section 170 because a deduction under that section is available only for contributions to organizations "created or organized in the United States or any possession thereof." The rationale of Rev. Rul. 63-252 is that if the U.S. organization receives the contributions only for unrestricted use of the foreign organization, the foreign corporation is the actual recipient of the contributions and it would defeat the statute to allow the donor a charitable deduction.

If a foreign organization can be treated as the actual recipient when a U.S. organization receives funds earmarked for its use, the converse should also be true: a foreign organization that is credited with local currency to use in funding the program of a U.S. section 501(c)(3) organization should be treated as receiving the currency for the use of the U.S. organization. Accordingly, under the rationale of Rev. Rul. 63-252, the U.S. organization would be the actual recipient of the donation and the donation would qualify for deduction under section 170.

Section 170 does not, by its terms, require that a contribution be made directly to a section 501(c)(3) organization in order to qualify for the charitable deduction. Section 170(c) defines a "charitable contribution" as a "contribution or gift to or for the use of" an organization described in that subsection. The Fifth Circuit has construed the term "for the use of" to permit deduction of a donation to a missionary related to the donor where the donor did not wish to give directly to the church sponsoring the missionary because it disapproved of certain church activities. Winn v. Commissioner, 595 F.2d 1060 (5th Cir. 1979). Similarly, although the courts have divided as to whether parents may deduct payments to their children to support missionary work where the payments were required by the church sponsor, they have differed on the issue of whether the payments were controlled by or for the primary benefit of the church sponsor, not as to whether payments to a nonqualifying recipient for use in funding a section 501(c)(3) organization's program can qualify for deduction under section 170. Compare Brinley v. Commissioner, 782 F.2d 1326 (5th Cir. 1986) (deduction allowable) and White v. United States, 725 F.2d 1269 (10th Cir. 1984) (same) with Davis v. United States, 664 F. Supp. 468 (D. Idaho 1987) (deduction disallowed). See generallY. B. Bittker, Federal Taxation of Income, Estates and Gifts paragraph 35.1.2, at 35-6 to 35-7 (1981).

The missionary cases have all involved payments to related individuals. The principle established in those cases should apply with even greater force where, as would be the case in debt for charity swaps, payments would be made to an unrelated foreign organization, pursuant to an agreement satisfying the requirements of Rev. Rul. 66-79, for use in funding the U.S. section 501(c)(3) organization's programs. The U.S. organization would have no incentive to participate in the swap if the proceeds were not to be used in furtherance of its programs.

As explained in my letter to Senator Baucus dated December 10, 1987 (copy attached), it would severely limit the ability of U.S. charities to arrange debt for charity swaps with donated debt if Rev. Rul. 87-124 were construed to preclude a charitable deduction solely because local currency is credited to a foreign organization. Accordingly, we would appreciate an opportunity to meet with you for further discussion if you continue to have questions concerning this issue.

I am also enclosing, for your information, a copy of GCM 34062. As we discussed, and as the subsequent GCM (copy attached) acknowledges, the principle on which that GCM relied was overruled by Old Colony Trust Co. v. United States, 438 F.2d 684 (1st Cir. 1971), and Kaplan v. United States, 436 F.2d 799 (2d Cir. 1971). The Internal Revenue Service announced that it would follow Old Colony Trust and Kaplan in Rev. Rul. 74-523, 1974-2 C.B. 304.

Sincerely,

Terrill A. Hyde
Wilmer, Cutler &
Pickering
Washington, D.C.

cc:
The Honorable Peter McPherson
Deputy Secretary
Treasury Department

Kathryn Fuller, Esq.
Executive Vice President
World Wildlife Fund

December 10, 198

The Honorable Max Baucus
Chairman
Senate Finance Subcommittee on
Taxation and Debt Management
United States Senate
706 Hart Senate Office Building
Washington, D.C. 20510

BEST AVAILABLE COPY

Dear Senator Baucus:

The day before the Subcommittee on Taxation and Debt Management's November 13 hearing on S. 1781, Treasury published a revenue ruling (Rev. Rul. 87-124) intended to accomplish the same objective as the proposed legislation, i.e., provide lenders a full cost basis deduction for donations of third world debt to fund charitable activities in the debtor nations. In its hearing testimony, Treasury took the position that the ruling rendered the proposed legislation unnecessary. World Wildlife Fund ("WWF") did not receive the ruling sufficiently before the hearing to determine whether it indeed obviated the need for the legislation. WWF did, however, express concern about certain aspects of the ruling, and Senator Chafee requested that it submit comments for the record after it had had an opportunity more fully to evaluate the ruling. Those comments are presented in this letter.

Rev. Rul. 87-124 describes a transaction in which a U.S. bank holding a U.S. dollar denominated debt obligation ("U.S. debt") of the central bank of a foreign country exchanges the debt for local currency. The central bank credits the local currency to an account of a U.S. charitable organization described in section 170(c)(2) of the Internal Revenue Code. The U.S. charitable organization is required to use the local currency in the foreign country for charitable purposes meeting the requirements of section 170. The ruling concludes that the bank recognizes a loss on the exchange of the U.S. debt for the local currency in an amount equal to the difference between its basis in the debt and the value of the currency and is entitled to a charitable contribution deduction equal to the value of the local currency.

The structure of the transaction described in Rev. Rul. 87-124 is quite different from the structure that would be permitted under the proposed legislation. If S. 1781 is enacted, the bank would be permitted to contribute the U.S. debt directly to the U.S. charitable organization. The organization could then arrange the debt for nature swap without the necessity for further U.S. bank participation.

At the hearing, WWF expressed concern with two aspects of the ruling. The first related to whether structuring the transaction as an exchange of debt with the central bank rather than as a charitable contribution would affect the accounting treatment of the transaction. As a result of discussions with bank financial officers and accounting firms subsequent to the hearings, WWF has concluded that the accounting effect of the exchange and donation described in the ruling should be substantially similar to that of the direct donation contemplated under S. 1781.

The second area of concern is not as readily resolved. The problem arises because the debt for nature swaps that have already been arranged or are currently under consideration do not resemble the transaction described in the ruling. Those swaps generally involve an exchange of U.S. debt acquired by a U.S. charitable organization for debt denominated in the local currency ("L.C. debt"). The L.C. debt may have terms substantially similar to those of the U.S. debt for which it was exchanged. The L.C. debt is generally credited to an entity organized in the foreign jurisdiction rather than to the U.S. charitable organization. Sovereignty concerns of developing countries may make it difficult or impossible to arrange a swap that involves crediting local currency to a U.S. organization as contemplated in the ruling (see attached letter to Marjorie Roberts, Treasury Office of Tax Legislative Counsel, from Kathryn S. Fuller, WWF Executive Vice President and General Counsel). However, if the L.C. debt were credited to a foreign entity in a transaction otherwise structured in accordance with Rev. Rul 87-124, the bank might not qualify for a charitable contribution deduction because section 170(c) permits deductions only for contributions to domestic organizations.

In order for conservation organizations to avail themselves of the ruling in structuring debt for nature swaps, it will be necessary to expand the scope of the ruling. This can be accomplished in two ways. First, Treasury should confirm that an exchange of U.S. debt for L.C. debt (as opposed to the exchange of U.S. debt for local currency) will be treated as a taxable exchange. Second, Treasury should establish guidelines under which the issuance of local currency or L.C. debt to a foreign entity to fund a charitable program in cooperation with a U.S. organization will be treated as a contribution directly to the U.S. organization. These guidelines should be as flexible as possible in order to permit the government of the developing country maximum control in administering expenditures to fund what it would rightfully regard as sovereign functions.

WWF remains hopeful that Rev. Rul. 87-124 may yet prove a useful tool in effecting debt for nature swaps. However, until Treasury provides assurances that it will construe the ruling expansively in order to permit conservation organizations to respect the sovereignty concerns of developing countries, WWF continues to believe that S. 1781 is necessary to foster such swaps.

Sincerely,

Terrill A. Hyde
Wilmer, Cutler &
Pickering
Washington, D.C.

cc:
Senator John H. Chafee
Marjorie Roberts, Esq.
Kathryn S. Fuller, Esq.

November 30, 1987

Ms. Marjorie Roberts
Office of Tax Legislative Counsel
U.S. Treasury Department, Room 4021
15th and Pennsylvania Avenue, NW
Washington, DC 20020

Re: Debt for Conservation Swaps

Dear Marjorie:

This letter responds to your request for information concerning problems that may be encountered in persuading developing countries to fund debt-conservation swaps by crediting local currency to the account of a U.S. charitable organization. Our experiences and those of our counsel, Michael Chamberlin of Shearman & Sterling, lead us to believe that our ability to persuade developing countries to accept such an approach would be problematical.

Our experience has been that countries typically place various restrictions on payment of proceeds; these restrictions are designed to ensure that the proceeds are used in the local country for the approved purpose within the approved time frame. Countries are becoming increasingly sensitive on issues of patrimony and local control. We believe that they can be expected to be particularly sensitive where as here the proceeds would be used to assist with sovereign functions such as the purchase and operation of park land. Many of the local regulations for debt-equity swaps were developed in the context of commercial transactions involving equity investments in which the local currency proceeds of the swap are required to be credited directly to the local company in which the investment is being made. In some cases, disbursements are even further restricted by requiring that proceeds be disbursed only directly to suppliers to, or creditors of, the local company.

Typically, different countries conduct debt-equity transactions in different ways and the rules they use are often not written down. However, we believe, based on prior experience, that the relevant authorities of countries such as Mexico, Chile, Venezuela, Ecuador, the Philippines and Argentina would raise difficulties with and in fact might not approve the crediting of local currency to a U.S. organization. This list is not exhaustive as we have not had experience exploring debt-conservation swaps with many developing countries.

These are some of the major difficulties we believe will arise in structuring swaps to conform to the transaction described in Revenue Ruling 87-124. We hope we will be able to work with you in defining circumstances under which the crediting of local currency to the account of a local entity to further purposes of the U.S. organization will be treated as a contribution to the U.S. organization. We appreciate your cooperation and assistance in this matter.

Sincerely,

Kathryn S. Fuller
Executive Vice President
and General Counsel
World Wildlife Fund
Washington, D.C.

FULL TEXT: SALMON AND GANDER SAY DEALERS SHOULD BE PERMITTED INSTALLMENT TREATMENT FOR SALE OF NONINVENTORY.

(Section 453 – Installment Method)

February 19, 1988

Dennis E. Ross, Esq.
Tax Legislative Counsel
Office of Assistant Secretary of Treasury
for Tax Policy
Department of Treasury
Room 3064
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Dear Dennis:

I have described below an issue concerning the amendment in the Revenue Act of 1987, P.L. 100-203 (the "Act"), that appears to eliminate the availability of installment sale treatment for certain dispositions of personal property by dealers. This issue is one that we believe should be addressed in any effort to make technical corrections to the 1987 tax bill.

As you know, the Act amended section 453(b)(2)(A) of the Code to provide that an "installment sale" does not include "[a]ny dealer disposition." New section 453(1)(1) defines "dealer disposition" as "[a]ny disposition of personal property by a person who regularly sells or otherwise disposes of personal property on the installment plan." We understand that this definition was drafted to track the language in prior law section 453A(a)(1), which prior to the Act provided that dealers were allowed installment sale treatment for sales of personal property that would generally be inventory. /1/

The intent of the Act was to eliminate the advantage section 453A extended to certain dealers of personal property that is unavailable to non-dealers because section 453(b)(2) provides that a disposition of inventory is not eligible for installment sale treatment.

If the amendments made by the Act to section 453(b)(2) and (3) are read broadly, however, dealers of personal property will be disadvantaged relative to non-dealers because dealers will not be able to elect installment sale treatment for dispositions of any personal property, even if the property is not of a type that the dealer regularly offers for sale on the installment plan. As a policy matter, such a discriminatory rule seems unsupportable. If a non-dealer can elect installment sale treatment on the disposition of a non-inventory asset, a segment of its business or stock of a subsidiary that is not publicly traded, why should a dealer be precluded from receiving similar treatment merely because it sells inventory on an installment plan? These infrequent types of asset sales are clearly not sales of personal property that the dealer "regularly sells or otherwise disposes of . . . on the installment plan" and therefore should not be covered by new section 453(1)(1)(A).

Under prior law, the occasional sale of non-inventoriable property by a dealer was eligible for installment sale treatment as a casual sale of personal property under section 453(b)(1). To ensure the continued availability of the installment method for a dealer's sales of personal property of a type not covered by old section 453A, a technical correction should be made to the definition of a "dealer disposition" in section 453(1)(1)(A) as follows:

"Any disposition of personal property by a person who regularly sells or otherwise disposes of personal property OF THE SAME TYPE on the installment plan." (Emphasis indicates required amendment.)

This technical correction is consistent with the history of the amendment made in the Act. The Conference Committee report states that "[t]he Conference agreement follows the Senate amendment." H.R. Rep. No. 495, 100th Cong., 1st Sess. 928. The original Senate Finance Committee report provided that a "dealer disposition" was limited to "any disposition of personal property by a person who regularly sells or otherwise disposes of property OF SUCH TYPE on the installment plan." S. Rep. No. ___, 100th Cong., 1st Sess. 162 (Oct. 16, 1987) (emphasis added). Section 6503 of the original Senate bill also defined "dealer disposition" as set forth above in the proposed technical correction. We believe that the original Senate Finance Committee language "of the same type" reflects the intent behind the amendment and was only inadvertently omitted from the language ultimately passed by the Senate and agreed to in the Conference Committee.

If you have any questions regarding the above, please call either John Salmon or Fred Gander.

Sincerely,

John J. Salmon

Fred R. Gander

Dewey, Ballantine,
Bushby, Palmer & Wood
Washington, D.C.

FOOTNOTE

/1/ Prior to the Act, section 453A(a)(1) defined a dealer as: "a person who regularly sells or otherwise disposes of personal property on the installment plan." Compare this language to section 453C(e)(1)(A)(i)(I), which prior to the Act referred to a dealer as: "a person who regularly sells or otherwise disposes of personal property OF THE SAME TYPE on the installment plan." (Emphasis added.)

FULL TEXT: EDWARDS OBJECTS TO DEFINITION OF UBTI UNDER NEW TAX-EXEMPT ENTITY ALLOCATION RULES.

(Section 501 – Tax-Exempt Organizations)

February 17, 1988

Ellen Aprill, Esq.
Office of Tax Legislative Counsel
1500 Pennsylvania Avenue, NW
Room 4013
Washington, D.C. 20220

Re: Technical Corrections Act, I.R.C. section 501(c)(25)

Dear Ms. Aprill:

Although I hope that we can discuss issues affecting section 501(c)(25) for most of our meeting on Monday, I would be glad to discuss the section 514(c)(9) allocation issue that you raised. In this regard, I have enclosed a memorandum that our firm prepared on the allocation issue. As you know, Akin Gump has been more active on the allocation issue than my firm, so Howard Jacobson should be able to discuss this with you on a detailed basis if you wish.

On the section 501(c)(25) issues, I have enclosed a summary of the legislative history of section 514(c)(9)(C)(iii) and a statement from the Policy Economics Group regarding the revenue assumptions used in the Tax Reform Act of 1986.

I look forward to our meeting at 1:30 p.m. on Monday.

Sincerely,

Tony M. Edwards
Morrison & Foerster
Washington, D.C.

Enclosures

January 7, 1988

MEMORANDUM ON PARTNERSHIP ALLOCATIONS AMONG TAX-EXEMPT AND TAXABLE ORGANIZATIONS

The Revenue Act of 1987, which was signed into law on December 22, 1987 as part of the Omnibus Budget Reconciliation Act of 1987, contains provisions that will affect investment in real estate by partnerships and joint ventures between tax-exempt and taxable entities. Specifically, these provisions will make it more difficult for tax-exempt entities investing in partnerships and joint ventures to avoid unrelated business taxable income ("UBTI") from debt- financed projects.

BACKGROUND

An organization exempt from income tax under Code Section 501 is nevertheless generally subject to income tax on its UBTI under Sections 501(b) and 511(b).* Under Sections 512(a), 512(c) and 513(b), UBTI is income of an exempt organization derived from any trade or business regularly carried on by it or a partnership of which it is a member.

UBTI generally does not include dividends, interest, annuities, royalties, and rents from real property (rents from personal property not incidental to real property are UBTI). Section 512(b). UBTI also does not include gains and losses from the sale of capital assets and other non-inventory property (such as commercial real estate). Section 512(b).

However, certain items of income do constitute UBTI notwithstanding that they fall into one of the exempt categories described above. For example, subject to certain exceptions, income that is debt financed (including rents, interest, dividends and capital gains) is taxed as UBTI. Debt-financed income is derived from property held to produce income that is subject to "acquisition indebtedness." "Acquisition indebtedness" is, with respect to any debt-financed property, the unpaid amount of (i) the indebtedness incurred in acquiring or improving such property; (ii) the indebtedness incurred before the acquisition or improvement of such property if such indebtedness would not have been incurred but for such acquisition or improvement; and (iii) the indebtedness incurred after the acquisition or improvement of such property if such indebtedness would not have been incurred but for such acquisition or improvement and the incurrence of such indebtedness was reasonably foreseeable at the time of such acquisition or improvement. The amount included in income is the percentage of the total income derived from or on account of the property equal to the average acquisition indebtedness divided by the average adjusted basis of the property during the taxable year.

Section 514(c)(9) generally eliminates the acquisition indebtedness rules for qualifying real estate investments of pension, profit-sharing and stock bonus plans (including group trusts), certain educational organizations and section 501(c)(25) entities (collectively "Eligible Entities").

The exception to the UBTI rules under Section 514(c)(9) is available only if certain requirements are satisfied. The property's purchase price must be fixed at the time of its acquisition, without the possibility of fluctuation; the loan must provide for a fixed amount of principal and interest with no participations, "equity kickers" or payments contingent in amount or due date; no portion of property may be leased to the seller or to any person related to the seller; no portion of the property may be acquired from or leased to a person related to any qualified trust acquiring an interest in the property; and financing with respect to the property must not be provided by the seller, any person related to the seller, or any person related to any qualified trust acquiring an interest in the property.

PRE-1986 ACT RULES

Section 514(c)(9) also requires special rules when an Eligible Entity holds real property through a joint venture with a taxable organization. Before the Tax Reform Act of 1986 (the "1986 Act"), the exception under Section 514(c)(9) was available to an Eligible Entity that was a partner with a taxable entity only if (1) all partnership allocations were "qualified allocations" (i.e., consistent with the Eligible Entity's being allocated the same distributive share of each item of income, gain, loss, deduction and credit and such share remains the same during the ENTIRE period the entity is a partner in the partnership); and (2) the allocation had substantial economic effect under Section 704(b).

These limitations restricted the structuring of joint ventures between exempt and taxable entities when the joint venture held leveraged property. For example, the qualified allocation rules made it difficult to structure a change in the partners' allocable shares even when the change was triggered by an economic event, e.g. the successful development of an addition to an industrial park by the taxable partner.

1986 ACT

The 1986 Act liberalized the UBTI exception to allow partnership allocations that were either "qualified allocations" or, if the allocations were not qualified, the principal purpose of the allocations could not be the avoidance of tax. This liberalization permitted tax-exempt partners to qualify for the Section 514(c)(9) exception when their allocable shares of income or loss changed during the life of the joint venture because of economic reasons.

NEW LAW

Under the Revenue Act of 1987, in order to avoid UBTI on debt-financed real property in a partnership or joint venture containing tax-exempt and taxable members, it is no longer enough that a non- qualified allocation not have as its principal purpose the avoidance of tax. The new law requires, in addition to all the other requirements of pre-existing law, that allocations that are not qualified allocations satisfy a new test.

This test requires that throughout the entire period that a tax-exempt entity is a partner (i) no distributive share of overall partnership loss allocable to a taxable partner can exceed such partner's smallest distributive share of overall partnership income

Testimony For Jack R. Stokvis

Good afternoon Mr. Chairman. I am Jack Stokvis, General Deputy Assistant Secretary for Community Planning and Development in HUD.

CPD has the lead responsibility for Enterprise Zones within HUD.

I appreciate the opportunity to testify. As you know, federal Enterprise Zone legislation has been a goal of both President Reagan and Secretary Pierce since 1982. We commend Senator Danforth for his long-standing interest in this concept and particularly his consistent championing of the special concerns of rural areas, especially in Missouri.

I understand that the Committee would like me to address three areas:

1. Our observations about State Enterprise Zones;
2. Our comments on S.983, the proposed Rural Enterprise Zone Act of 1987; and
3. How HUD would administer the program if the bill is enacted.

The experience of State Enterprise Zones is testimony to the power of an idea.

Connecticut and Florida started the ball rolling in 1982 by moving ahead with their own programs without waiting for federal legislation.

Our latest count is that 35 states and the District of Columbia have adopted the Enterprise Zone concept in one form or another.

Of these, twenty six states and the District have designated at least one zone. New York is the most recent with 10 zones under its Economic Development zones program.

Maine and Arizona have most recently enacted Enterprise Zones legislation.

Also, just this year, the Texas legislature revised its program to decouple it from federal legislation, and Texas is now implementing its program. We understand that there is now some consideration being given in Rhode Island to doing the same thing.

Several other states are giving serious consideration to Enterprise Zone legislation, including Wisconsin, Utah and Massachusetts.

Business Facilities Magazine has reported 67,400 jobs retained, 113,600 new jobs created and $8.8 billion of investment in State-created zones.

While impressive, these numbers are in a sense less important than the point that Enterprise Zones have emerged as a significant new tool in economic development.

And that is what they are--tools which can be used in conjunction with other tools.

There has been an amazing variety in the approaches of the states to Enterprise Zones.

Some state programs are oriented toward heavy industry, some to light industry or warehousing, others to retail.

Some states provide a specfic residential component, some don't.

Whatever their original objectives, Enterprise Zones are an evolving experience. Enough so that states are adjusting their programs: some by revising their incentives, others by making structural changes in their programs.

At the state level, Enterprise Zones have increasingly become a way of focusing resources and coordinating state economic development efforts.

At both the state and local levels, Enterprise Zones offer an encouraging linkage between economic development (job creation) and employment development and training, as well as linking and leveraging many other forms of support, including transportation, infrastructure, and seed money for small business.

Another development which is particularly pertinent to this hearing is the use of Enterprise Zones in small towns and rural areas.

We have observed this for some time and covered it in our January 1986 issue of Enterprise Zone Notes which incidentially, featured rural zones in Missouri, including Cuba, Missouri.

Several states specifically provide for a mix between urban and rural zones; others simply permit it.

In general, the approach in small town and rural zones is to emphasize business retention and modest expansion.

To show the interest in this area, Alabama recently amended its program by specifically providing for rural zones, and that is now the major emphasis of that states' program.

First, I want to applaud Senator Danforth for his continued support of Enterprise Zones at the federal level.

We in the Administration believe that, notwithstanding the success of state zones there is still a role for the federal government--and that role should be to supplement and encourage the state efforts.

I believe that consideration of this bill will help move that discussion forward.

With regard to S. 983 itself, we have two comments:

1. The Administration's Enterprise Zone proposals have consistently been comprehensive, covering both urban and rural areas, as well as Indian Reservations. We believe that Enterprise Zones are a tool for helping to revitalize economically distressed areas of all types throughout the country; and

2. With respect to the bill's incentive package; we note that although relatively modest, several of the incentives would have revenue implications. In light of the deficit, we are not prepared to embrace specific tax incentives at this time. However, we endorse the idea of coordination of federal programs and the idea of giving "special assistance" by federal agencies in support of Enterprise Zones. This has already happened on both a formal and informal basis.

I'm happy to conclude on a positive note. We at HUD have been planning for implementation of Enterprise Zones since 1982.

Accordingly, we will be prepared to publish regulations within the time frames specified in the bill, and follow up with the specifics of the nomination and review processes, if S.983 or similar legilation is signed into law.

We have planned a major role for our field offices in the review process, and will provide outreach to potential nominees--building on the experience of the states.

Let me close by assuring the Committee that the Administration remains committed to Enterprise Zones and looks forward to working with you in determining an appropriate federal role.

STATEMENT OF

HONORABLE FRANK S. SWAIN

I appreciate the opportunity to be here today to testify on a subject of major concern to you and the Small Business Administration-rural economic revitalization. It is my firm belief that the small businesses of our Nation must be major participants in successful rural economic development and job generation.

Since March of this year, U.S. Small Business Administration Administrator James Abdnor has made rural economic development one of his top three priorities. SBA is working with other Federal and state agencies to develop creative responses to rural economic problems which do not increase the deficit and which encourage rural economic diversification.

As you well know, the economic outlook in rural America has not been encouraging. On average, rural residents earn less and more often live in substandard housing and poverty than their urban counterparts. Rural residents earn about 70 percent of the average annual income of urban residents - $10,000 per year versus $14,000 per year. Fourteen percent of rural resident incomes fall below the poverty line, compared to 11 percent in urban areas. Of the rural population over 25, 58 percent have not completed high school. While 24 percent of the total population lives in non-metropolitan counties, over 39 percent of the Nation's substandard housing is found there.

More than 35 percent of the nation's elderly live in non-metropolitan counties, contributing to a greater need for medical services in the rural population.

The shift in the focus of American industry - from predominately resource extraction and manufacturing industries to increasing service or information based industries - has created economic difficulties for rural communities tied to the old resource based industries.

The majority of small farmers already derive over half of their income off the farm. We are seeing heightened activity in home-based businesses to supplement this income. While the numbers are difficult to quantify, it is interesting to note that of the 10 Home Based Business Conferences that SBA recently conducted, two with significant rural populations, Wichita, Kansas, and Missoula, Montana, had the highest attendance. Aside from traditional cottage industries, SBA is also planning training sessions to increase small business owners' ability to use computers, which could be of great benefit to rural small businesses. The SBA Office of Business Development is working with IBM and the Lotus Development Company to sponsor a series of training conferences on computers and small business, which we anticipate will begin in the Spring of 1988.

However, rural communities generally offer few new job opportunities. The necessity to seek jobs farther from home exacerbates the problems - businesses that provide goods and services in the local community are closing because workers are making purchases nearer their place of work.

Even those employees involved in the older "rural" industries often no longer live in rural communities. For example, in farming and related agricultural enterprises, which account for over 21 percent of total U.S. employment, more than 62 percent of those agriculture related jobs are now found in metropolitan areas. Thus, while many city workers are directly dependent on agriculture for their jobs, they are no longer dependent on rural communities. Other resource -based rural industries can be similarly traced.

Role of Small Business in the Rural Economy

Rural development policy includes many components that affect and are affected by a healthy small business community. Small business is shouldering a large portion of the national burden of job creation and innovation - creating over 60 percent of the net new jobs, providing 55 percent of all employment, and generating nearly 40 percent of the gross national product. So, it is natural to look to small business to stimulate growth in rural areas. Currently, small firms (those with fewer than 500 employers) provide employment for 56 percent of non-metropolitan workers, compared to 47 percent for the U.S. as a whole.

In the last eight to ten years the United States has created 15 million new jobs. However, this is largely an urban phenomenon. In rural areas small firms are not contributing new jobs at the same rate as in urban areas. Between 1976 and 1984 the number of jobs in firms with fewer than 500 employees grew 31 percent in urban areas and only 23 percent in rural areas. We are also finding that the growth that does occur in rural areas receives a greater boost from large firms, primarily in the health services, financial services, and educational service areas.

Since small business is the chief job generator in our country, policies to rejuvenate our rural areas should be policies that promote the formation and expansion of small business. This challenge is intensified by some of the demographic changes that we expect will affect the entire economy over the next 15 years. First among them is the slowing of the population that grew at almost 2 percent in the 1950s. By the year 2000 it is anticipated that our population and our work force will be growing at less than 1 percent per year. This means there will be more older workers, and it means that there will be essentially no growth in the number of entry level workers. If people are leaving a community anyway, the challenge to employers, to our educational system, and to economic development is intensified.

The Federal Role in Rural Diversification

How should the government respond to these diverse and complex economic and demographic changes? We are challenged to focus on the appropriate roles of Federal, state, and local government and - especially in a time of fiscal restraint - to determine how best to pay for needed services.

There are several tools available to promote economic growth. Some involve better use of existing resources, reducing legal and regulatory burdens, and targeted assistance. S. 983, which would authorize the establishment of up to 45 rural enterprise zones, would target assistance to specific rural, impoverished areas. We supported earlier Federal enterprise zone proposals, and we continue to support the enterprise zone concept at the state level. Over 30 states have demonstrated that it works. Clearly, enterprise zones - urban, rural, and on Indian reservations - are an important economic development tool. According to a 1985 study prepared for our office and a 1986 Department of Housing and Urban Development report on urban enterprise zones have produced a positive impact on business investment; they are serving a vital role as a catalyst for local business activity.[1] Business Facilities magazine has reported 67,400 jobs retained, 113,600 new jobs created, and $8.8 billion have been invested in the zones.

Partially initiated in anticipation of a Federal enterprise zone statute, state enterprise zone laws have successfully evolved on their own. The incremental benefits of Federal rural enterprise zones legislation would assist designated areas. However, increased concern for Federal deficits and the need to allow the 1986 tax reform to take full effect leads me to conclude that other steps to assist rural communities may be more practical at this time.

Rather than new programs or more money, the single request that I hear most from small business is for better coordination among Federal agencies and among Federal, state, local, and private sources of rural economic development assistance. Rural economic development is the responsibility of several Federal agencies, including SBA, FMHA, Cooperative Extension Service, HUD, EDA, and others. In addition, as you know, the Domestic Policy Council established a task force on rural communities in August 1986.

SBA Administrator Abdnor feels the best approach at this time is to coordinate with other Federal, state, and local agencies and governments to provide a special emphasis to rural, economically impoverished areas. These could include more efficient linking of existing services, expedited processing, priority funding, program set asides, and technical assistance.

SBA Administrator Abdnor is planning a series of field hearings and conferences to focus on the awareness of rural economic needs and to determine how small business development can be strengthened in rural areas.

At SBA our concern for rural development, for state programs to finance small businesses, for the impact of state employer benefit mandates, has led the Office of Advocacy to target this year's annual conference for state and local legislators on these issues. We are holding this meeting in San Antonio, Texas, next week, from November 17-19. We certainly hope that your state and local legislators interested in rural economic development will attend.

As we attempt to revitalize businesses in rural areas, we urge the Congress to review other small business issues which can enhance this climate.

Barriers

Many Federal and state policies serve as "domestic barriers" to international competitiveness and economic development. These policies tend to be those that impose disproportionate regulatory burdens on small firms, restrict the ability of a small business to react quickly to changing markets or to increase employment. Thus, current Congressional debates on mandated health benefits, family leave, and minimum wage all have important rural and small business implications. At the same time, I am concerned about inaction on needed reforms such as product liability and transportation deregulation.

Again, let me assure you of the firm commitment of the Small Business Administration to rural economic development. We look forward to working with you in full cooperation and partnership.

Thank you for this opportunity. I will be pleased to respond to your questions.

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[1] Susan A. Jones, Allen R. Marshall and Glen E. Weisbrod, Business Impacts of State Enterprise Zones (Cambridge, Massachusetts: prepared for the U.S. Small Business Administration by Cambridge Systematics, Inc., September 1985); Office of Program Analysis and Evaluation, State-Designated Enterprise Zones: Ten Case Studies (Washington, D.C.: U.S. Government Printing Office, August 1986).

STATEMENT OF MICHAEL ALLAN WOLF

For the past five years, primarily in my capacity as Director of the EZ (Enterprise Zone) Project, I have studied the EZ phenomenon and its various manifestations on the state and local levels throughout the United States. The use of EZs--geographically targeting tax, financing, and regulatory incentives to a depressed region in order to encourage economic redevelopment and revitalization--is the latest in a long line of urban and rural redevelopment efforts that seek to create and maintain an effective public-private partnership.

In a dramatic reversal of the trends that have characterized American governance in the post-New Deal decades, state and local lawmakers, administrators, and bureaucrats have taken up the EZ gauntlet from a hesitant federal government, promulgating and implementing an impressive array of zone programs. While federal zone legislation remains unenacted, in twenty-six states legislative and regulatory efforts have begun to reap the intended benefits of economic redevelopment and/or neighborhood renewal. More than a handful of states are waiting in the wings.

Zones have been designated, in accordance with state guidelines, in Arkansas, California, Colorado, Connecticut, Delaware, Florida, Georgia, Illinois, Indiana, Kansas, Kentucky, Louisiana, Maryland, Michigan, Minnesota, Mississippi, Missouri, Nevada, New Jersey, New York, Ohio, Oklahoma, Oregon, Pennsylvania, Vermont, and Virginia. This is truly a national phenomenon that cannot be labeled "eastern" or "southern," nor "urban" or "rural." (See Table 1.) Arizona and Maine, with new legislation, as well as Alabama, Texas, and West Virginia (three states in the EZ fold in name only until very recently) are anticipating joining the ranks of active states as well. Tennessee, Hawaii, and the District of Columbia are still awaiting stronger governmental commitments before setting their zone programs in motion.

By no means, however, is all rosy and blissful in zones, for there still exist designated areas that reflect no appreciable increase in economic activity, areas that could best be characterized as warehouse districts, and areas in which the same level of investment and employment would have occurred without state and local zone incentives. Despite these qualifications, however, and despite the fact that we are still within the early stages of the EZ phenomenon, it can be safely asserted that many enterprise zones in America are working. Several zone programs, in terms of increased employment and capital expenditure and of innovative public sector decisionmaking and administration, as well in symbolic ways harder to quantify but no less real, are well on the way to fulfilling the goals envisioned by legislators and other policy makers.

The "state laboratory" presents dramatic contrasts--the small business incubator facility in a depressed Chicago neighborhood and the expansive Almonaster-Micheau Industrial District in East New Orleans. In some areas, there is a special historical flavor--as in Tampa´s Ybor City zone or New Britain´s downtown zone. In other areas, like Chicago´s stockyards, old memories make way for new economic realities. Entire towns, such as Cuba, Missouri, and Thief River Falls, Minnesota, have been swept up in EZ fever.

The level of geographic identity of zones varies as well. The Park Circle EZ is the economic focal point of Baltimore´s Park Heights neighborhood, while hundreds of Florida (first-round) and Louisiana EZs function (or fail to function) in anonymous census tracts groupings.

Some zones foster public awareness. A billboard welcomes customers, visitors, and potential investors to the Park Circle Zone. Control Data, which runs a Business and Technology Center in the zone, encourages neighborhood students to take advantage of its computer facilities. Newsletters report on area economic and social activities in the New Britain and Baltimore zones.

There are zones that feature one key employer, such as the newly renovated Speigel Company in Chicago's Back of the Yards EZ. In New Britain, zone benefits have aided large and small businesses, residential owners, and others located downtown. Louisville's expansive EZ encompasses a wide range of residential, commercial, and industrial uses, all hoping to benefit from the EZ umbrella.

The public sector role varies as well. The negotiating skills of state and local officials were probably more important than any zone incentives to Speigel officials whose construction plans seemed inconsistent with local fire codes. One major office developer in New Britain purchased its formerly industrial property in a deal orchestrated by state and local economic development officials. Ybor City officials stress the importance of governmental carrots, not federal or state funds, to businesses interested in zone investment. Large- and small-scale infrastructure commitments have enhanced zone attractiveness and profitability as well in Louisville and elsewhere. To many state and local zone officials, linkage of EZs to preexisting job training, fixed asset financing, redevelopment, and planning programs has been the keys to revitalization within zone borders. In Cuba, contacts with a nearby state university have led to significant improvements in the business climate of the zone.

Workers and employers within and around the zone display varying levels of awareness and satisfaction with EZs. More than one business person has stated that, though EZ incentives were not the major reason for the decision to locate in the zone, even their role as "icing on the cake" was appreciated. Some entrepreneurs express hope that lawmakers would someday enhance available incentives, particularly those geared to venture capital. A number of employees sensed that the key contribution made by the EZ program was symbolic: finally something positive was happening in an area recently characterized by blight and stagnation.

As with most of the best-laid redevelopment schemes, there exist gaps between the concept and the reality of EZs. For example, with but a few minor exceptions, deregulation is not playing a key role in attracting zone businesses. In some municipalities that contain zones, some attention has been paid to streamlining the approval process, by preparing guidelines for developers, offering counseling, and the like. But one of the great fears raised by early zone critics--that EZs would mean a weakening, if not the elimination, of regulations protecting wages, safety, etc.--has not, as yet, materialized.

It is difficult to make general conclusions about state and local EZs, particularly at this early stage of their development; yet there are certain patterns that emerge. Some states could initially be categorized as "wait and see," holding their enacted legislation back until Congress acts. While Texas has moved away from a federal zone "prerequisite," and while language concerning federal zones remains a vestige in the legislation creating active programs like Virginia´s, Rhode Island zones still await a federal trigger. A second group of states have packaged existing incentives or have relabeled other kinds of initiatives under the rubric "enterprise zones," in a process that could be called "promise them anything but call them EZs." For example, Minnesota´s "border city" zones seems but a new name for the same interstate struggle for jobs. The remaining states are "taking the plunge," designating and implementing legislative and administrative incentives in hundreds of jurisdictions throughout the country.

Notwithstanding the weakly supported assertions of zone proponents and opponents, it is still too early to call American EZs an unqualified success or failure. If all were perfect, we would not be seeing the refinements anticipated for, or already made in, existing programs (from minor modifications to Florida´s decision to move to a new EZ regime). If there were no redeeming qualities, it is doubtful that we would continue to hear the proposals we do for targeted incentive programs in non-zone states.

These hearings in consideration of S. 983, The Rural Enterprise Zone Act of 1987, are a further indication that the EZ phenomenon is alive and well. While tax reform and deficit reduction battles have relegated federal EZs to the back burner, there has been a great deal of fruitful state and local activity from which Washington may learn.

Indeed, EZs seem to be entering a second phase in their history. The first phase consisted of elaborate theory and grand plans. Imported from Great Britain by way of the Heritage Foundation and the American Legislative Exchange Council, EZs originally meant a federal, supply-side, anti-regulation, conservative program to attract new, small business to the inner city. The rhetoric that continues to center around this original conception is, however, uninformed and inaccurate.

During the second phase of EZs, there have been many departures from the original concepts: The reality in phase two is that--at their most effective--EZs are state and local, public-private, re-regulatory partnerships, passed and endorsed by liberals, moderates, and conservatives alike, not only to attract small, moderate, and larger employers to, but also to retain existing businesses in, urban, rural, and suburban areas.

Rural enterprise zone proposals are an important component of this second phase. While the earliest programs were generally targeted to blighted areas of the central city, the rural set-aside quickly became a familiar feature of zone legislative proposals (even in Congress). Nonurban zones are already operative in Arkansas, Kansas, Mississippi, Minnesota, and several other states. Nearly all of the newest state programs--those in Vermont, West Virginia, Colorado, Maine, Oregon, Hawaii, Arizona, and New York--are directed significantly to non-urban areas.

The program encompassed in S. 983 could be an attractive complement to the rural zone efforts in these and other states. The designation criteria should ensure that many existing zones will be eligible to compete for federal REZ selection. The "Required state and local commitments" outlined in proposed Section 7891(d) of the Internal Revenue Code virtually describe many of the activities already in motion in state-designated zones.

Based on extensive contact over the past few years with private sector investors and their advisers interested in zone incentives, I feel comfortable in predicting that the implementation of the tax and financing incentives included in S. 983 would generate a great deal of activity in the targeted areas. Limiting the number of REZs to 45 (18 per year) will help to ensure a manageable experiment. The fact that zone incentives are not limited solely to manufacturers is also a positive component of the bill, as small commercial concerns and service industries have been some of the most active participants in state zones throughout the U.S.

This is not to say that there is no room for improvement. For example, making the tax credits refundable credits would allow new, struggling companies to take immediate advantage of this important incentive. Second, there is no maximum size limitation in the bill; this deletion could result in the designation of large, amorphous zones with no identifiable character. Third, the neighborhood participation provisions could be firmed up significantly. Fourth, there is no requirement that a qualified "rural enterprise zone business" make commitments regarding additions to the work force or increased capital investment; the danger here is that an "incentive-shopping" business could leave one location's economy to suffer while enhancing the zone's environment. Each of these potential weaknesses has been addressed in state EZ legislation currently in operation.

As the EZ movement continues apace, and as the barriers of rhetoric and impatience are hurdled, existing EZ programs (in Connecticut, Ohio, and Florida, to name but a few) have been modified to make state and local redevelopment and revitalization efforts more successful for public and private participants, and for the community at large. With legislative interest stirring in Congress, as well as in Utah, Iowa, Massachusetts, Wisconsin, and North Carolina, the future seems to hold even more EZs in store. If the past is any indication of the future, the coming years should offer even more lessons in innovation, creativity, and trial and error, as lawmakers strive to target capital and employment to the most depressed regions of the nation.

Table 1
Incentives available in existing state and local EZ programs[a]

A. Statutory authority	
Alabama (AL)	Ala. Code §11-40-16
Arkansas (AR)	Ark. Stat. Ann. §§9-1701 to -1710
California (CA)	Cal. Gov't Code §§7070–7077, 7080–7099[b]
Colorado (CO)	Colo. Rev. Stat. §§39-30-101 to -109
Connecticut (CT)	Conn. Gen. Stat. §§ 32-70 to -75
Florida (FL)	Fla. Stat. §§290.001–290.015[c]
Georgia (GA)	H.B. No. 629 (1982)
Hawaii (HI)	S.B. No. 2095-86
Illinois (IL)	Ill. Ann. Stat. Ch. 67 1/2, §§601–617
Indiana (IN)	Ind. Code Ann. §§4-4-6.1-1 to -8
Kansas (KS)	Kan. Stat. Ann. §§12–17, 107 to 17, 111
Kentucky (KY)	Ky. Rev. Stat. §§154.650–700
Louisiana (LA)	La. Rev. Stat. Ann. §§51:1781–1790
Maryland (MD)	Md. Ann. Code art. 41, §§266KK-1 to -5
Michigan (MI)	Mich. Comp. Laws Ann. §§125.2101–.2122
Minnesota (MN)	Minn. Stat. Ann. §§273.1312–.1314
Mississippi (MS)	Miss. Code Ann. §§57-51-1 to -15
Missouri (MO)	Mo. Ann. Stat. §§135.200–.255
Nevada (NV)	Nev. Rev. Stat. §§274.010–.300
New Jersey (NJ)	NJ Stat. Ann. §§52:27H-60 to -89
New York (NY)	N.Y. Gen. Mun. Law §§955–969
Ohio (OH)	Ohio Rev. Code Ann. §§5709.61–.66
Oklahoma (OK)	Okla. Stat. tit. 62, §§690.1–.17
Oregon (OR)	Or. Rev. Stat. §§284.110–.260
Pennsylvania (PA)	16 Pa. Code Ch. 23 (1983)[d]
Rhode Island (RI)	R.I. Gen. Laws §§42-64.3-1 to -11
Tennessee (TN)	Tenn. Code Ann. §§13-28-101 to -114
Texas (TX)	Tex. Rev. Civ. Stat. Ann. art. 5190.7
Vermont (VT)	Vt. Stat. Ann. tit. 10, §§691–698
Virginia (VA)	Va. Code §§59.1-270 to -284
West Virginia (WV)	W. Va. Code §§5B-2B-1 to -9
B. Tax incentives	
Property tax reduction or exemption	CT, GA, HI, IL, IN, KY, MD, MI, MN, MO, NY, OH, OR, PA, RI, TX
Franchise tax deferral	LA, NV, NJ, OH, TX, VA
Sales tax exemption on zone purchases and/or sales	AR, CO, CT, HI, IL, KS, KY, LA, MN, MS, NJ, NY, OK, TX, VA, WV
Investment tax credits for real improvements	CO, FL, IL, KS, MN, MO, NY, OK
Employee training expense credit	CT, IL, MO, NV, OH
Employer credit for selective hiring	AR, CA, CO, FL, HI, IN, KS, LA, MD, MO, NJ, NY, OH, RI, VT, WV
New job tax credit	AR, CO, CT, FL, IN, LA, MD, MS, MO, NJ, NY, OH, RI, VT

Table 1 (continued)

B. Tax incentives (continued)	
Income tax credit-employer	AR, CA, CO, CT, FL, HI, IL, IN, KS, LA, MD, MN, MS, MO, NJ, NY, OH, RI, VT, WV
Income tax deduction/credit-employee	CA, IN, RI
Community investment tax credits	FL, IL, PA, TN
Miscellaneous tax credits/reductions[e]	AL, CA, HI, IN, KY, MN, NV, NJ, NY, OH, PA, TN, TX, VA, WV
C. Capital financing	
Capital investment fund	CT, FL, IL, IN, MD, MS, NY, OK, PA
Bond support	CA, CT, FL, IL, KS, LA, MS, NV, NY, OK, TX, VT
Public/private support mix	CA, IL, IN, LA, MD, MN, MS, NV, OH, PA, VT
Tax increment financing	FL, IN, KS, MI, NV, NY, TX
D. Miscellaneous incentives	
Insurance for zone businesses	IL, NV
Regulatory relief	AL, AR, CA, HI, IL, IN, KY, LA, MI, MO, NV, NJ, NY, OH, OR, PA, RI, TN, TX, VA, WV
Public corp. created to provide services	CA, IL, IN, KY, NV, NJ, NY, PA, TN, TX

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[a] The information in table one is drawn in large part from the EZ Matrix that is published in the *EZ Gazette*. The most recent version of the Matrix (a graphic representation of the then-25 zone programs) was published in the winter of 1985. Single copies are available free of charge from the EZ Project, OCU School of Law, 2501 North Blackwelder, Oklahoma City, OK 73106.

[b] California features two zone programs enacted in 1984: The Enterprise Zone Act (sponsored by Assemblyman Pat Nolan), and The Employment and Economic Incentive Act (sponsored by Assemblywoman Maxine Waters).

[c] The state of Florida will be embarking on a second generation EZ program, effective January 1, 1987. Unlike the previous noncompetitive program, the new legislation authorizes the approval of 20 zones with enhanced incentives. Designation of zones under the 1982 legislation ended July 1, 1984.

[d] Pennsylvania's is an administrative program that recently received legislative support. *See, e.g.*, the Enterprise Zone Municipal Tax Exemption Reimbursement Act, Act No. 1986-108, 1986 Pa. Legis. Serv. 148 (Purdon).

[e] For example, the Tennessee legislation includes four interesting incentives: (1) a corporate excise tax credit (up to $100,000) for 20% of the amount contributed "to the creation, operation, maintenance, or improvement of public schools within an Enterprise Zone"; (2) exemption from state and local taxes of interest payments for certain EZ loans; (3) set-aside of "state educational assistance grants and guaranteed student loans" for qualified zone residents; and (4) set-aside of at least 10% of locally administered low interest loans "for use of qualified residents/owners in the enterprise zone".

Source: Wolf, Potential Legal Pitfalls Facing State and Local Enterprise Zones, 8 Urban Law & Policy 77, 119-20 (1986-87).

COMMUNICATIONS

LAGUNA INDUSTRIES, INC.
AND PUEBLO OF LAGUNA

The Indian Economic Development Act of 1987, S.788, H.R. 1759, would amend the Internal Revenue Code to establish Indian Enterprise Zones on or near Indian reservations. The Act seeks to attract industry to Indian reservations by providing tribal and federal tax benefits, regulatory relief, and streamlined approval processes. Indian lands would become eligible for enterprise zone designation based on the extent of a Tribe's economic depression, measured by unemployment rate or number of residents living below the poverty line. The federal tax benefits to an industry locating in an enterprise zone include tax credits for employing unemployed Indians, tax credits to investors who invest in tangible property in Indian enterprise zones, exclusion of certain capital gains from gross income, and favorable treatment for bond issues used to finance facilities in Indian enterprise zones. The designation of an Indian enterprise zone could remain in effect for up to 24 years. In addition, the Act provides for designation of foreign trade zones and ports-of-entry.

The Pueblo of Laguna has been trying to attract industrial development to its reservation for many years. The economic base of the Pueblo used to depend solely on uranium mining. When the Jackpile Uranium Mine at Laguna Pueblo closed down, the Pueblo sought to diversify its economic base. The Pueblo of Laguna has organized two tribal enterprises, Laguna Industries, Inc., In., and Laguna Commercial Enterprise. It is in the process of establishing Laguna Construction Company. Laguna Industries, Inc., is an industrial manufacturing enterprise which, under the minority owned business provisions of the Small Business Act, contracts with the U. S. Department of Defense. Laguna Commercial Enterprise operates a shopping center, including a grocery store and a gasoline station, on the reservation. Laguna Construction Company will carry out large earth moving and reclamation activities in conjunction with reclamation of the Jackpile Uranium Mine. In addition to forming these tribal enterprises, the Pueblo of Laguna seeks to attract off-reservation industry to locate on or near the reservation. The designation of certain parts of the Laguna reservation as an Indian enterprise zone would do much to attract industry to the reservation. The Pueblo of Laguna is willing to provide tax relief, a regulatory infrastructure, and streamlined governmental approval of industries willing to locate in an enterprise zone.

The Pueblo of Laguna and Laguna Industries, Inc., strongly support passage of the Indian Economic Development Act of 1987, with the following comments, recommendations and suggestions.

1. Laguna Industries, Inc., and the Pueblo of Laguna strongly support the concept of Indian Enterprise Zones, foreign-trade zones, and ports-of-entry. The incentives supplied by this bill for industries to locate in Indian enterprise zones are an excellent way of attracting industry to isolated rural reservations, which is one of our special concerns.

2. The Act provides that nominated areas will be eligible for designation as an Indian enterprise zone if they meet 1 of 3 criteria. We suggest that the 3rd criterion, that "at least 70 percent of the households living in the area have incomes below 80 percent of the median income of households of the local government" be eliminated entirely. This would mean deleting Section (c)(3)(C)(iii) of the proposed Subchapter D of Section 7881 of the Internal Revenue Code. The comparison of poverty on the reservation to poverty surrounding the reservation is irrelevant to a determination of the need for Indian enterprise zones. A Tribe in need of economic development might not meet this criterion if the surrounding area is very poor. To utilize such criteria would ultimately insure that impoverished areas of the country with sizeable reservation Indian populations would be certain to remain poor a cruel result which the bill does not intend. We suggest that the criteria of unemployment rate and poverty rate based on nationwide norms are sufficient for establishing the need on the reservation for an Indian enterprise zone. In addition, the term "local government", when speaking of the median income of "households of the local government", is ambiguous. Does "local government" mean tribal government or surrounding county government?

3. We support the idea that the criteria for certification by the Secretary, specifically unemployment rate and poverty rate, be in the alternative, as the Act now provides. A Tribe may comply with the unemployment rate criterion, and not comply with the poverty rate criterion, or vice versa. It should not have to meet both criteria.

4. Title III of the Act, regarding establishment of foreign trade zones in Indian enterprise zones, should be changed to provide for specific amendment of the Foreign Trade Zone Act of June 18, 1934, codified at 19 U.S.C. Section 81a-81u. Title III now provides simply that the Foreign Trade Zone Board would consider on a priority basis and to the maximum extent possible applications for foreign trade zone status from Indian enterprise zones. However, the Foreign Trade Zone Act of June 18, 1934 provides only for locating foreign trade zones within States. We recommend that the definitions section of the Foreign Trade Zone Act, 19 U.S.C. Section 81a, be amended to define "Tribe" and "Indian enterprise zone". The Foreign Trade Zone Act refers repeatedly to the location of foreign trade zones in States, and to cooperation by the Foreign Trade Zone Board with States, subdivisions, and municipalities. All references to States in the

Foreign Trade Zone Act need to be amended to refer also to "Tribe", "tribal", and to "Indian enterprise zones". The following sections need to be amended in this manner: 19 U.S.C. Section 81a, Section 81i, and Section 81o.

5. We support the provision in Section 231(c) which allows Indian tribes to issue private activity bonds. It is important that this concept remain in the Act. However, it is unclear whether the Committee also intends to remove the "essential governmental function" requirement on general tribal tax-exempt bonds. The Act strikes out subsection (c) of the Indian Tribal Governmental Tax Status Act of 1983, 26 U.S.C. Section 7871. Subsection (c)(1) of the Tax Status Act requires that tribal tax-exempt bonds be used only for "essential government services." We support eliminating this requirement, but are uncertain whether the Committee intends this result. If the Committee does intend this result, it should make it clear in the legislative history of this Act. If not, the Committee should clarify the current Act.

6. A general concern of ours is that the Secretary not show any favoritism in designating Indian Enterprise Zones. There will obviously be strong competition between neighboring tribes to acquire an Enterprise Zone. If one tribe receives an enterprise zone and a nearby, equally qualified tribe does not receive one, the second tribe will be severely disadvantaged in attracting new development. The Act should instruct the Secretary to consider each tribe on an equal footing with other tribes when selecting sites for enterprise zones.

7. There should be no time limit on the Secretary's opportunity to designate Indian enterprise zones. Title I, Section 101(a) proposes that the Secretary shall only designate Indian enterprise zones during the 36 month period following issuance of the implementing regulations. This is an unnecessary restriction. Designation of enterprise zones should be an ongoing process. Some tribes may not have the regulatory infrastructure for enterprise zones in place when the regulations are issued. They should not be denied the opportunity to designate enterprise zones by an arbitrary 36 month cutoff date.

I thank you for this opportunity to present the views of Laguna Industries, Inc., and the Pueblo of Laguna. We urge the Committee and the Congress to pass this legislation with the few changes we have suggested.

Ronald J. Solimon

Ronald J. Solimon
President
Laguna Industries, Inc.

The
Morgan
Bank

December 9, 1987

Submitted Statement
of
Rodney B. Wagner, Executive Vice President,
Morgan Guaranty Trust Company
on
S.1781 -- Charitable Deduction for
Debt of Developing Countries

The Morgan Bank strongly supports and urges passage of S.1781, which provides a cost basis deduction for charitable contributions of third world debt to support international conservation efforts. We believe that debt for nature swaps could be a valuable component of preservation efforts by conservation organizations in third world countries, and that enactment of this legislation would encourage lenders to make debt available to facilitate such swaps.

Under current tax law, the amount of the tax deduction is limited to the fair market value of the debt. Current law thus produces a disincentive for banks to make charitable contributions of third world debt by depriving them of the tax loss they would otherwise realize if they sold the debt or held it until it could be written down for tax purposes. For example, if a lender sells debt with a cost basis of $1,000,000 for $300,000 and donates the proceeds to charity, it would be able to deduct a $700,000 loss on the sale and would also receive a $300,000 charitable deduction. However, if it simply donates the debt to the charity, it would have to forego the loss and would be limited to a $300,000 charitable deduction (the market value of the debt).

Conservation organizations believe more contributions would be received from lenders if the contributions were made in the form of third world debt rather than dollars. It is often difficult to sell LDC debt in many of the LDC countries in large amounts and in order to adjust these loans a lender would be willing to consider a charitable contribution. Morgan agrees with this assessment and, as a lender holding a portfolio of third world debt, believes lenders would be interested in such a program. It would, however, be difficult for a lender to justify a contribution of debt rather than dollars if it were necessary to forego the tax loss.

Under the bill, the entire cost basis of debt donated for conservation purposes would be treated as a charitable deduction. Treasury has indicated that it would prefer to limit the charitable deduction to the value of the debt and treat the difference between the value and the cost basis as a loss. We would have no objection to the change suggested by Treasury.

In closing, we wish to express our hope that members of the Senate Finance Committee will not confuse the issues presented by S.1781 with broader third world debt issues, such as accounting treatment and forgiveness. S.1781 was conceived of by conservation organizations as an imaginative tool to assist with the overwhelming problem that confronts them in funding conservation programs in third world countries that are frequently too burdened with debt and other economic problems to justify expenditures for such programs.

We support S.1781 because it will enable us to enhance the value of our charitable gifts to support international conservation. We would be happy to respond to any questions members or their staffs may have concerning our interest in the proposal.

The Shoshone-Bannock Tribes

FORT HALL INDIAN RESERVATION
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FORT HALL BUSINESS COUNCIL
P. O. BOX 306
FORT HALL, IDAHO 83203

November 16, 1987

The Honorable Lloyd Bentson, Chairman
Senate Finance Committee
SD 205 Dirksen
Washington, D.C. 20510

Dear Senator Bentson:

The Shoshone-Bannock Tribes (Tribes) of the Fort Hall Indian Reservation in Idaho territory appreciate the opportunity to testify at the November 12, 1987 hearings on the Indian Economic Development Act of 1987 (Act). Please include in the record this letter and the enclosed testimony of Dr. Charles Pace, Tribal Economist, which expands upon his remarks at the hearings. There is an urgent need for economic development in Indian country and the Tribes strongly endorse the intent of the Act, i.e., to alleviate poverty and unemployment on Indian reservations.

Allowing tribes to issue private activity bonds will remove much uncertainty that surrounds the tax-exempt status of tribal obligations. Currently, there is so much uncertainty regarding the tax status of tribal obligations that it is virtually impossible for tribes to issue tax-exempt securities. The provisions in subtitle D of the Act will encourage tribes and the financial community to make the required commitment of time, money, and effort required to access the financial markets on attractive terms.

It is also appropriate for Congress to provide federal tax credits for increased economic activity within designated Indian enterprise zones. Tax credits for employment, credits for investment, and exclusion from gross income of capital gains on property in Indian enterprise zones are powerful tools of fiscal policy that can be brought to bear to improve the quality of life on reservations and in adjacent areas.

We understand that, even though the Act promotes and is consistent with the Administration's policy of self-sufficiency and self-determination for Indian people, Treasury officials are reluctant to endorse the creation of

Senator Bentson
November 16, 1987
Page Two

Indian enterprise zones because of the potential impact on federal tax receipts. We believe that Treasury's concerns are unwarranted.

For new enterprises that are created within Indian enterprise zones as a result of the Act, the impact on Treasury's tax receipts will be positive. The concern centers primarily on existing off-reservation businesses that relocate on-reservation simply to shelter corporate income from federal taxation. However, even in this unlikely case, we believe that the reduction in transfer payments that will result from new employment opportunities on-reservation, combined with the income leakage off-reservation, will generate a net increase in federal tax receipts.

The Tribes are concerned that, in implementing the Act, the Secretary of Interior might inadvertently pit tribes against each other in seeking Secretarial approval of a nominated area. Initially, the Indian enterprise zone concept might be implemented on a trial basis for specific reservations. We believe that, ultimately, criteria should be established and Secretarial approval should be forthcoming for any nominated area that meets the criteria.

We appreciate the Committee's interest in Indian affairs and thank you for inviting us to testify at the hearings.

Sincerely,

Marvin D. Osborne

Marvin D. Osborne
Chairman, Fort Hall Business Council

cc: Secretary of Interior
Assistant Secretary for Indian Affairs

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